



NONPROFITS: INTERNAL REVENUE SERVICE

# Denials of 501(c)(3) Tax Exemption: A New Study

03.28.18 | Linda J. Rosenthal, JD



For nonprofit law and policy geeks interested in the decision process of the IRS for 501(c)(3) tax exemptions, there's an important recent study available online through the [Social Science Research Network \(SSRN\)](#).

Professor Terri Lynn Helge of Texas A&M University School of Law has written a first-of-its-kind analysis of IRS denials of Form 1023 (and 1023-EZ) exemption applications for the period 2004 through January 31, 2017. At 78 pages, it is a full-blown law review article published in the University of Pittsburgh School of Law's [Pittsburgh Tax Review](#). There are exhaustive legal citations and all of the usual bells and whistles of scholarly work, but it's presented in a refreshing plain-English style sure to be appreciated by geeks and non-geeks alike.

## Scope of Exemption Denial Analysis

In [Rejecting Charity: Why the IRS Denies Tax Exemption to 501\(c\)\(3\) Applicants](#), Professor Helge presents a five-part analysis. She begins in Part I with a helpful refresher of the key requirements to demonstrate qualification for exemption under Internal Revenue Code section 501(c)(3). In later sections, she keeps to that framework in analyzing, for instance, which are the most prevalent deficiencies that result in application rejections.

Why is this analysis "the first of its kind"? The primary reason is lack of information about tax-exemption denials before 2004; afterward, an obstacle was the tedious process of retrieval. For 501(c)(3) approvals, the "determination letter" approving the exemption *and* the underlying application are publicly available, either on request from the IRS or from the organization itself. For 501(c)(3) denials, though, the situation has been different. Before 2004, neither the Form 1023 nor the IRS's file materials including correspondence explaining the rationale for rejecting were



publicly available. Under a December 2003 federal court order, the IRS began releasing the denial letters albeit with the identifying information of the applicants redacted. “These denial letters provide an important source of information about the criteria the Service uses to evaluate charitable organization exemption applications.” But, while this information officially became available, it rarely saw the light of day.

“While others have commented on isolated denial letters, this study is the first to conduct a comprehensive analysis of the Internal Revenue Service denial letters issued from that date [i.e., 2004] through [the cut-off date selected for study purposes of] January 31, 2017.” With the help of a research team, Professor Helge examined each and every one of 603 determination letters in which the IRS denied an exemption, with an “in-depth” look at the “basis on which” the IRS denied the application.

In the final section, Part V, she includes criticism of the Form 1023-EZ, which has been in effect as an alternative for many applicants beginning in mid-2014, as well as the related issue of the lack of funding and personnel at the IRS to conduct sufficient oversight of the charitable sector.

## *Primary Reasons for Exemption Denials*

In Part III, Professor Helge reports on the data findings and analyses. Of the original 603 cases reviewed, a small number were omitted because of too little information available.

Of the remaining 588 denial letters studied, “the primary basis for denying an applicant’s request for charitable status is the applicant’s failure to meet the operational test and violation of the prohibition on private inurement and, to a lesser extent, the applicant’s failure to meet the organizational test.” Only 9 were denied because of “substantial lobbying activity,” and (only) 4 on the grounds of political campaign activity. But, “[i]n many of the denial letters, the Service cited multiple reasons why a particular applicant did not satisfy the five-part test for exemption.”

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*My study reveals that the operational test is the key factor in determining that an applicant does not qualify for exempt status. The operational test is comprised of many facets. Over half of the applicants failing to meet the operational test were engaged in substantial commercial business activities and therefore posed a threat to leveraging the tax exemption as a competitive advantage in their respective marketplaces.*

She notes that “[t]he Service appears firmly entrenched in the ‘primary purpose’ test in evaluating potential commercial activity... and has nearly abandoned the ‘commensurate in scope’ test.”

There’s another interesting observation: “In evaluating private inurement claims, the Service is heavily focused on nonprofit governance and appears to encourage compliance with governance best practices as a condition to receiving exemption.” Noting that there has been criticism in some quarters of the federal agency “enforcing governance practice in this manner” – it’s generally considered a state-law issue – she writes that “it would be helpful for the Service to issue published



guidance describing its requirements in this area.” This would help tax-exemption applicants in the future and also “prevent the Service from applying varying ad hoc requirements in similar situations.”

## *Form 1023-EZ Exemption Process*

Professor Helge’s evaluation of the new Form 1023-EZ streamlined application procedure focuses on the skimpy disclosures required. With little information presented, the IRS cannot make a meaningful decision on qualification for 501(c)(3) status. Many of the applications sail on through with no problem upfront, but then, on later examination, disqualifying deficiencies surface. For instance, an organization using an online, one-size-fits-all template for its articles of incorporation can easily omit language required to meet the organizational test. During the ordinary (non-fast-track) review of a regular Form 1023 application, the examiner will let the organization know about the easily-correctable omission. Without that fix at the early stage, an approved organization faces a full-blown, retroactive revocation of tax exemption.

Recently, Washington policymakers have recognized the need for a somewhat fuller disclosure requirement for the Form 1023-EZ, and have made some changes, somewhat beefing up the requirements.

## *Conclusion*

This project is an important contribution to research in the field of 501(c)(3) tax law and policy.

Professor Helge indicates that her next study will focus on the determination letters from the same 2004-early 2017 period in which the IRS has *revoked* 501(c)(3) tax exemptions.

By the way, the [Social Science Research Network](#) (SSRN), responsible for free-of-charge access to this scholarship, is a valuable source of information on a wide variety of topics; check it out.