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IRS

New Reports on IRS Oversight of Nonprofits

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An article in The New Republic several weeks ago – *There's Never Been a Better Time to Be a Scammy Nonprofit* (August 29, 2022) Jasper Craven – was sadly accurate. That was the lead-in to our September 7th post, *Nonprofits & IRS: Square Peg, Round Hole*.

Two new official reports by the Treasury Inspector General for Tax Administration (TIGTA) now document with hard data the dire problems plaguing the Internal Revenue Service's oversight of exempt organizations. See:

- More Information Is Needed to Make Informed Decisions on Streamlined Applications for Tax Exemption (October 3, 2022)
- Review of the IRS's Enforcement Program for Tax-Exempt Organizations That Participate in Illegal or Nonexempt Activities (September 29, 2022)

The Historical Context

It wasn't always this way.

There was a time when the IRS Exempt Organizations Branch "… was adequately structured, funded, and staffed to provide not only meaningful supervision of, but also assistance to, the nation's tax-exempt organizations." In *Nonprofits & IRS: Square Peg, Round Hole*, I reminisce about being there several decades ago in the Washington, D.C. National Office as well as the Los Angeles field office.

Later, though, Congress made a number of moves knee-capping the agency's ability to function successfully as the nation's premier regulator of charitable organizations and other tax-exempt nonprofits.

It's not unfair to mention, though, that Treasury and the IRS exempt-organizations leadership have also taken actions that, while well-intentioned, have further crippled this vital oversight role. The

most notable example is the decision in mid-2014 to address the staggering backlog of tax-exemption applications by adopting the dramatically streamlined short-form 1023-EZ.

We'll start with that problem: the subject of the second-in-time (October 3rd) TIFTA Report. It was a controversial move from the beginning. The Form 1023-EZ was set in motion despite vigorous warnings from a broad spectrum of the nonprofit community, albeit all outside the IRS.

TIFTA on Form 1023-EZ

In More Information Is Needed to Make Informed Decisions on Streamlined Applications for Tax Exemption (October 3, 2022) [37 pages including an introductory "highlights" page], the Treasury Inspector for Tax Administration pulls few punches in its conclusion that the Form 1023-EZ has been a dismal failure.

In the "highlights" summary, TIGTA explained why it did this audit. "The overall objective of this review was to assess the efficiency of the streamlined application process for recognition of tax-exempt status under Internal Revenue Code (I.R.C.) § 501(c)(3), including 1) whether the application provides the IRS with sufficient information to approve or deny the organization for tax-exempt status, and 2) the use of resources and processing times in making determinations."

The title of the report is a bit on the mushy side in an apparent attempt not to offend the agency leadership. Notwithstanding that goal of a soft landing, the contents of the report are relatively hard-hitting.

Little of it is a surprise because in the 8 years or so since the Form 1023-EZ's adoption, there's been no dearth of thoughtful criticism including the observation by the National Council of Nonprofits's CEO, Tim Delaney, a few years ago, that it's easier to get a tax exemption than a library card.

The TIGTA report authors concluded: "The ease with which individuals can apply for and receive tax-exempt status using the Form 1023-EZ streamlined application demonstrates the importance of requiring more detailed information during the application process. These weaknesses, coupled with the fact that less than 1 percent of tax-exempt organizations are examined each year, increases the risk of fraudulent or ineligible organizations receiving tax-exempt status and operating with little chance of detection." They noted particular concerns that "… fictitious organizations that may potentially commit illegal acts, such as preying on unsuspecting taxpayers for donations or funding terrorist organizations" can achieve tax-exempt status.

Notwithstanding the dismal findings based on cold facts and figures, the upshot of the report is four weak recommendations:

- "revise the activities description narrative on Form 1023-EZ,
- assess the feasibility of requiring applicants to submit their organizing documents as an attachment to Form 1023-EZ,
- notify applicants when additional time is needed to process their Form 1023-EZ applications, and
- update online guidance with accurate information on the application process for Form 1023-EZ filers."

But even these suggestions for measly tweaks were not fully embraced; "IRS management agreed [only] with the second and fourth recommendations." See Appendix III; see also TIGTA's reply to leadership's response in Appendix IV.

The bottom line, apparent to almost everyone, is that the solution needed for the Form 1023-EZ is not tweaking it around the edges by – for instance – asking applicants to provide an extra document or a slightly beefed-up narrative of proposed activities.

The remedy – at the very least – is to dump the Form 1023-EZ and start over.

But the problem goes deeper, as shown in part by the other of the two recent TIFTA reports. The agency's tax-exemption oversight function is too badly wounded for band-aid fixes. See discussion in *Nonprofits & IRS: Square Peg, Round Hole*.

TIFTA on Fraudulent Organizations

In Review of the IRS's Enforcement Program for Tax-Exempt Organizations That Participate in Illegal or Nonexempt Activities (September 29, 2022) [33 pages including an introductory "highlights" page], the Treasury Inspector for Tax Administration issued a report that "leaves a lot to be desired."

Rep. Bill Pascrell, Jr., (D-NJ), chair of the House Ways and Means Subcommittee on Oversight, asked TIGTA to conduct this audit. The "overall objective … was to assess the IRS's ability to identify tax-exempt organizations potentially involved in illegal or nonexempt activities and the processes in place when potential illegal or nonexempt activities are identified."

The TIGTA authors found – in this review as in earlier ones – that "the IRS has processes in place to identify whether a tax-exempt organization engages in substantial activities that do not further its tax-exempt purpose." The agency also "has processes in place to receive information from third parties, such as State law enforcement, on tax-exempt organizations potentially involved in illegal or nonexempt activities. However, due to the complexities of the law, there is limited collaboration with third parties to actively identify noncompliance."

Moreover, "… the IRS function responsible for deciding the examination potential of referrals determined that few alleging illegal or fraudulent activity by tax-exempt organizations warrant examinations." Also, "… information entered into the IRS's referral database is not always accurate or complete."

The authors made three recommendations:

- "ensure that Classification managers periodically emphasize to classifiers the importance of including supporting documentation in the case files for selecting or not selecting referrals for examination
- implement referral database system controls to ensure that complete and accurate data is input into the database and
- review the fields on the referral database and determine if any may be eliminated to avoid confusion, conflicting information in similar fields, and redundancy."

The IRS "agreed" with all three and "agreed to take corrective action."

Paul Streckfus, editor of the EO Tax Journal [paywall] finds this report "… astounding" for several reasons including the finding that "… of 3,726 cases referred to the EO function as compliance risks potentially involving illegal or fraudulent activity for the period 2018-2020, it appears that none of them were examined for reasons including: "insufficient corroborating evidence," statute of limitations problems, or allegations described as "de minimus." See *Email Update 2022-187* (Tuesday, October 11, 2022).

It also conflicts with anecdotal evidence he receives from attorneys and accountants that "they have stopped filing complaints with the IRS about wayward exempt organizations because nothing ever happens…."

Mr. Streckfus also notes that the relatively "rosy scenario" painted by the conclusions in the September 29th report conflicts with the TIGTA authors' mention there of the "substantial deficiencies" found in the companion report on the flawed Form 1023-EZ. "For example," the October 3rd report notes that "in May 2022, the Brooklyn District Attorney's Office indicted a man on charges of grand larceny, identity theft, and conducting a scheme to defraud by allegedly forming 23 fraudulent charitable entities and collecting at least $152,000 in donations. Per [TIFTA's] data analysis, the IRS approved 56 Forms 1023-EZ applications submitted by this individual in FYs 2019 and 2020, all with the same address."

Conclusion

Of course, the almost daily news stories around the nation exposing scam nonprofits – including many created by the rich and famous – undermine the somewhat understated conclusions by TIFTA in the September 29th report on the government's ability to stop organizations engaged in fraudulent or illegal activities.

And, in particular, the Oversight subcommittee chair is not amused. See *Pascrell Blasts Damning Report of Systemic IRS Failings*, October 7, 2022, *Press Release*, U.S. Rep. Bill Pascrell, Jr. ["Watchdog investigation reveals 'insufficient' IRS process approved 80% of fake charities"].

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