

Nonprofits & IRS: Square Peg, Round Hole

09.07.22 | Linda J. Rosenthal, JD



The title of the just-published article in *The New Republic* says it all: [There's Never Been a Better Time to Be a Scammy Nonprofit.](#)

In his insightful piece, journalist Jasper Craven on August 29, 2022, aptly sums up the crescendo of alarm from nonprofit-sector leaders, professional advisers, academics, expert commentators – and even government regulators – about the now-clear inability of the Internal Revenue Service to provide effective oversight.

No one takes pleasure lobbing these concerns and criticisms about the federal agency that several decades ago was adequately structured, funded, and staffed to provide not only meaningful supervision of, but also assistance to, the nation's tax-exempt organizations.

Readers of Paul Streckfus's excellent daily subscription newsletter, the [EO Tax Journal](#), will recognize this sentiment about the EO Division's heyday, particularly during the 1970's. That decade opened just as the [comprehensive Tax Reform Act of 1969](#) went into effect. This landmark legislation introduced the concept of the "private foundation" including the significant restrictions and excise taxes that go along with that new designation.

By the time I started at the National Office as a rookie Tax Law Specialist just out of law school in 1977, Paul, who came in 1972, was writing and coordinating the release of EO revenue rulings in the EO Division. These were based on the most challenging tax-exemption determinations cases and rulings requests. We were assigned cases (with increasing complexity depending on our relative levels of experience) that had been referred by one of the regional offices or otherwise marked right off the bat as needing National Office attention.

After moving to California in 1979, for two years I was able to see the operations from the field-office perspective as well. The Los Angeles office was the EO hub for the Western states. It was well staffed. We – (with the front-end applications-approval responsibilities) – worked side by side with a

much larger contingent of experienced exempt-organizations revenue agents.

On both coasts, there was a sense of mission. We joked that we were the only part of the IRS that *gave away* money (through exemptions from taxation) instead of collecting it.

An important part of the job was helping worthy and well-intentioned new organizations, particularly the many that were proceeding *pro se*, to navigate the complexities of the Form 1023 application process. We had both the training *and* the time to do it effectively. The ultimate proof of success: fan mail and offers of flowers, lunches, and gifts, the latter all politely declined because of strict agency regulations limiting freebies to no more than a cup of coffee.

Seriously, in what other division of the IRS do staffers get fan mail?

Of course, this sense of mission was manifested as well through the all-important rigorous spotting of bad apples and weeding them out. Those years were – much more than now – decidedly *not* a good time to be a “scammy nonprofit.”

A Look Back

In his August 29th article, author Jasper Craven correctly notes: “Effective oversight is vital for the nonprofit world to thrive. It can discourage misconduct, make cheated parties whole, and ensure a group’s mission is met. When the system works correctly, bad actors are brought to justice.”

“Despite budgetary challenges,” he explains, “the IRS has shown itself to be a capable regulator,” adding: “In the 1970s, agents righteously investigated private tax-exempt Southern schools that had imposed de facto segregation. Many other shady actors were caught through audits and random application reviews. Through this work emerged institutional knowledge and legal theories that helped clarify vague statutes.”

Mr. Craven also favorably describes subsequent periods up to and including the 1990-2000 time frame when Marcus Owens (also a ‘70’s staffer) ran the EO Division. He “had a fleet of about 120 lawyers and certified accountants. In addition to their core oversight work, employees fanned out to field offices to train other IRS officials on the ins and outs of nonprofit regulation. They also released continuing education materials every year that featured evolving guidance.”

With retrospectives along the same lines are: *How the IRS’s Nonprofit Division Got So Dysfunctional* (May 17, 2013) Kim Barker and Justin Elliott, *propublica.org*. and *Exile to Main Street: The I.R.S.’s Diminished Role in Overseeing Tax-Exempt Organizations*, Professor Evelyn Brody and Marcus Owens, Esq., (2016) 91 Chicago-Kent Law Review 859.

The Dismantling Begins

“What had been a somewhat effective EO Division prior to 2000 was ‘kneecapped through the IRS Restructuring and Reform Act of 1998,” writes Mr. Streckfus in EO Tax Journal 2022-154 (August 15, 2022) commenting on Jasper Craven’s about-to-be-published *New Republic* article.

The New Republic (2022) article, the Pro Publica (2013) piece, and the Chicago-Kent law review treatise (2016) all fill in key gaps in our collective understanding of how and why the federal exempt-organizations regulatory function disintegrated so spectacularly in the last two decades.

The usual “Why can’t the IRS regulate nonprofits anymore” conversation tends to focus on the last 10 to 12 years beginning with the so-called Tea Party/501(c)(4) “scandal.” It’s important to note that, eventually, the underlying premise was debunked as false. “The office was flagging groups all over the spectrum, and its enhanced reviews rarely led to denials....Still, the IRS is an easy enemy, and once again became Congress’s cat toy.”

Most particularly, these three sets of commentators correctly start their detailed analyses of the EO function dismantling with the 1998 IRS restructuring statute. It was intended to “modernize” the agency and shift its focus to customer service. But there was severe fallout on the exempt-organizations division.

“Moves launched in the 1990s were designed to streamline the tax agency and make it more efficient. But they had unintended consequences for the IRS’s Exempt Organizations division,” note the *Pro Publica* authors. “Checks and balances once in place were taken away. Guidance frequently published by the IRS and closely read by tax lawyers and nonprofits disappeared ... All this combined to create an isolated office in Cincinnati, plagued by ... ‘insufficient oversight’ of fewer than 200 low-level employees responsible for reviewing more than 60,000 nonprofit applications a year.”

They continue: “... [T]he IRS once had a system in place to review how applications were being handled and to flag potentially problematic ones. The IRS also used to show its hand publicly, by publishing educational articles for agents, issuing many more rulings, and openly flagging which kind of nonprofit applications would get a more thorough review.”

The Withering Continues

The Tea Party “scandal” that blew up at the time the *Pro Publica* authors were writing their article in 2013 was a “perfect storm” of everything that had gone wrong, ignited by baseless political hysteria. The cases that were at the center of this 501(c)(4)/social welfare brouhaha had landed in the Cincinnati hub and – unfortunately – stayed parked there.

The IRS Exempt Organization branch “... has always had to deal with controversial groups. For decades, the division periodically listed red flags that would merit an application being sent to the [Washington, D.C.] headquarters for review,” according to Marcus Owens, interviewed for the 2013 article.

That *Pro Publica* article also includes this observation from Paul Streckfus: In the 1970s, ... “many more applications came to Washington to be worked — the idea was to have the most sensitive ones come to Washington.”

And Milt Cerny, the EO branch chief back then (and whom I fondly recall interviewing me for my job) also contributed thoughts to the 2013 article: “We had developed a broad group of tax experts to deal with these issues.” In the 1980s, he recalled, they “...issued many more ‘revenue rulings’” which, along with the Treasury regulations, were important guideposts for the public. “We would do a revenue ruling, so the public and agents would know Over the years, it apparently was felt that a revenue ruling should only be published at an extraordinary time. So today [i.e., 2013] you’re lucky if you get one a year. Sometimes it’s less than that. It’s amazing to me.”

The 2019 Law

There have been additional major developments in recent years which are deftly discussed in Jasper Craven's article last week in *The New Republic*.

With the crumbling of the IRS's oversight function also came an explosion of new organizations seeking tax exemption, fueled to some extent by the 2010 *Citizens United* Supreme Court decision. In 2014, the IRS launched a quick fix, emergency remedy for the massive backlog of exemption applications. The new Form 1023-EZ has been a spectacular failure. "It's easier to get a tax-exemption than a library card," said National Council of Nonprofits CEO, Tim Delaney a few years ago.

The calls to ditch the Form 1023-EZ continue. See *Representative Introduces Bill to Replace Form 1023EZ* (April 28, 2022) Professor Philip Hackney, *Nonprofit Blogger*.

It's "... about to get a lot worse," writes Jasper Craven, "thanks to a 2019 law pushed by [the former president] that's forcing the IRS to essentially dismantle" the exempt-organizations regulatory part of the agency.

Once again, it's a matter of generalized agency-wide restructuring statutes compounding exponentially the pre-existing problem of the IRS's exempt-organizations regulatory duties being a square peg in a round hole." "[A]mong other things," the 2019 statute "makes it harder for nonprofits that haven't filed the proper paperwork to lose their status." Documents laying out the broad reorganization further demonstrate that the EO office is set to be scrapped, with responsibilities divvied up to other parts of the agency.

"For all intents and purposes," says Marcus Owens for this August 2022 article, "the IRS is getting out of the tax-exempt services business."

Alternatives?

"As the IRS retreats," according to Jasper Craven, "what remains is a series of piecemeal and imperfect oversight efforts. Attorneys general in states such as New York, California, and Massachusetts have stepped in to police nonprofits." Mr. Craven quotes Harvey Dale, who directs NYU's National Center on Philanthropy and the Law, to the effect that "these offices do good work, but have 'many other fish to fry.' More to the point, 'many states have no full-time employees focused on the sector.'"

And "one government lawyer vented that even if her state exposes scammers, many simply move and reregister in friendlier states." She said: "It's a game of whack-a-mole. And bad actors will simply relocate where there is very little or no regulation."

Conclusion

That square peg is never going to fit into that round hole.

As the "EO office withers" within the Internal Revenue Service, there have been voices for some time suggesting what once seemed unthinkable but now may be inevitable. See, for example: "*The Better Part of Valour Is Discretion: Should the IRS Change or Surrender Its Oversight of Tax-Exempt Organizations?*" (2016) Professor Lloyd H. Mayer, 7(1) *Columbia Journal of Tax Law* 80-122.

In his August 15, 2022, Email Update 2022-154, Mr. Streckfus writes: “With The Taxpayer First Act’s expected dismantling of the EO Division, now is the perfect time to get EO responsibilities out of the IRS into a separate, independent agency. I think such a move would have bipartisan support in the Congress.” But, the “...underlying problem, as I see it, is that bureaucracies (Treasury and IRS) never like to give up a piece of their turf lest they lose influence and resources.”

By the way, if it isn’t already obvious, I’m a big fan of the [Streckfus daily newsletter](#). All “[sophisticated EO tax practitioners](#)” should be following the in-depth news as well as the lively discussions that pop up in “The EOTJ Mailbag.” Among others, the former IRS officials named in this post join the conversation from time to time.

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