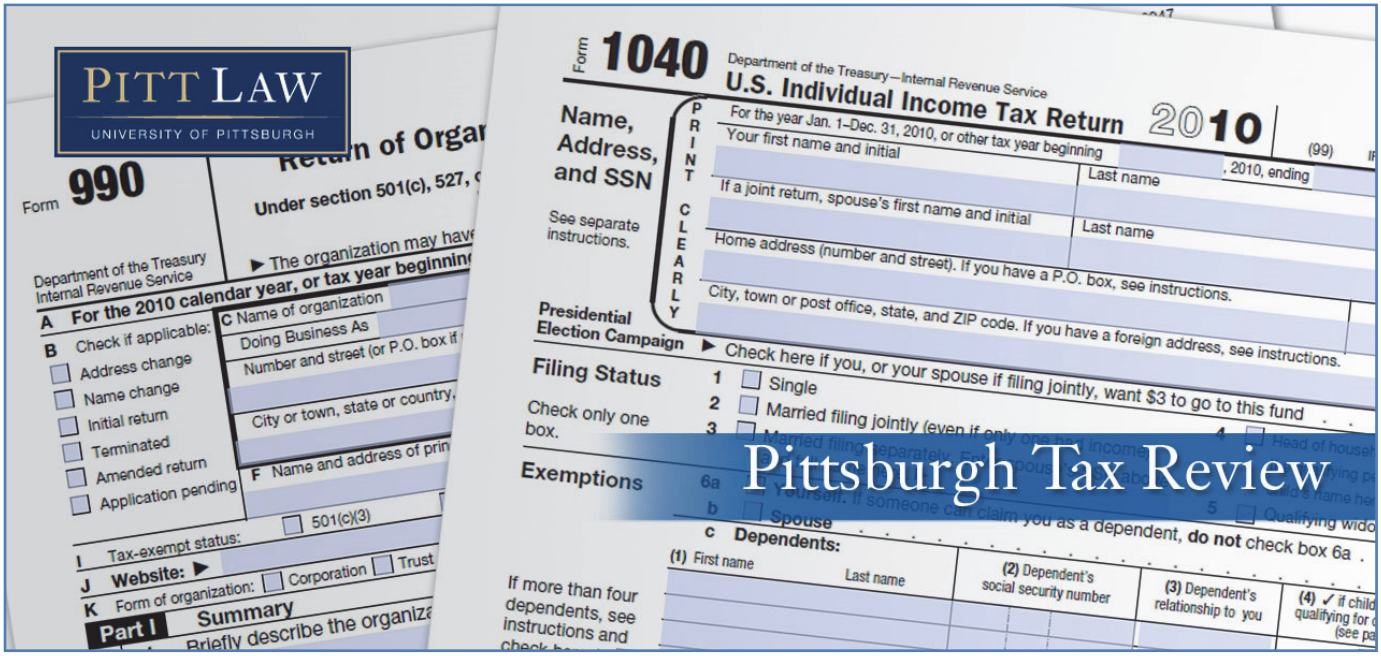

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ARTICLES

REJECTING CHARITY: WHY THE IRS DENIES TAX EXEMPTION TO 501(C)(3) APPLICANTS

Terri Lynn Helge

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ARTICLES

REJECTING CHARITY: WHY THE IRS DENIES TAX EXEMPTION TO 501(C)(3) APPLICANTS

Terri Lynn Helge[*]

INTRODUCTION

The Internal Revenue Service (Service) is charged with the oversight of tax-exempt charitable organizations.[1] As part of this oversight, new charitable organizations generally must file an application for exemption (Form 1023)[2] and await approval from the Service. The Service approves of the organization's charitable status under Section 501(c)(3) by issuing a determination letter to the organization. This determination by the Service not only exempts the charitable organization from federal income tax[3] but also enables the charitable organization to receive tax-deductible charitable

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[*] Professor of Law, Texas A&M University School of Law. I am very grateful to Johnny Rex Buckles, Bryan Camp, Susan Morse, Dennis Drapkin and Calvin Johnson for their helpful comments and suggestions on earlier drafts of this Article. I also thank the participants of the 2015 AALS Nonprofit Committee Symposium on Charitable Organizations Oversight, the 2016 Texas Tax Scholars Workshop and the Texas A&M Law School Faculty Scholarship Workshop.

[1] The Internal Revenue Service's oversight power stems from the tax exemption afforded to charitable organizations in the Internal Revenue Code. *See* I.R.C. § 501(a), (c)(3). Until the enactment of the federal tax laws applicable to charitable organizations beginning in the early 20th century, oversight of the charitable sector was reserved exclusively to the stated. *See* MARION R. FREMONT-SMITH, GOVERNING NONPROFIT ORGANIZATIONS: FEDERAL AND STATE LAW AND REGULATION 54–55 (2004).

[2] Treas. Reg. § 1.501(a)-1(a)(3). Qualifying organizations may file Form 1023-EZ, Streamlined Application for Recognition of Exemption Under Section 501(c)(3), instead of Form 1023. *See infra* nn.183–88 and accompanying text. Organizations with annual gross receipts of $5,000 or less and churches are not required to file an application for exemption (Form 1023) to be recognized as a charitable organization described in Section 501(c)(3). I.R.C. § 508(c). However, many churches voluntarily file the application for exemption in order to receive an Service determination letter to provide evidence to potential donors that the church is recognized as exempt by the Service.

[3] *See* I.R.C. § 501(a).

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contributions from donors.[4] Furthermore, many state exemptions, such as exemption from income tax, sales tax, and property tax, rely at least in part on a determination from the Service that the organization qualifies as a charitable organization described in Section 501(c)(3).[5] Accordingly, the Service serves a role as an important gatekeeper to determine which applicants qualify as "charitable" and deserving of these special privileges.[6]

Unfortunately, the criteria the Service uses to evaluate applications has not always been transparent. If an application is approved, the Service determination letter and the application for exemption are required to be made publicly available[7] and can be requested from the Service or the organization itself.[8] However, the determination letter does not set forth the reasons why the organization's application was approved but instead only states that the organization qualifies for exemption, the effective date of the exemption, and the organization's classification as a public charity or private foundation.

Prior to 2004, in the case of denials, neither the application nor the Service's correspondence setting forth its rationale for the denial were made publicly available.[9] In December 2003, the District of Columbia Circuit Court ruled that the Service was required to make these denial letters publicly

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[4] *See* I.R.C. § 170.

[5] *See I.R.S. Publication 4220*, Applying for 501(c)(3) Tax-Exempt Status, at 2. *But see* 1 INTERNAL REVENUE SERV. NAT'L TAXPAYER ADVOCATE, *MSP #19: Form 1023-EZ: The IRS's Reliance on Form 1023-EZ Causes It to Erroneously Grant Internal Revenue Code 501(c)(3) Status to Unqualified Organizations*, *in* 2016 ANNUAL REPORT TO CONGRESS 253, at 257–58 [hereinafter NAT'L TAXPAYER ADVOCATE, *MSP #19]* (noting that one state charity official is considering whether to allow state exemptions based on determination letters from the Service that were granted as a result of the applicants filing Form 1023-EZ).

[6] *See* Terri Lynn Helge, *Policing the Good Guys: Regulation of the Charitable Sector Through a Federal Charity Oversight Board*, 19 CORNELL J.L. & PUB. POL'Y 1, 55–58 (2009) (discussing the importance of the federal tax laws in defining charitable activities and the enforcement of these laws by the Service).

[7] I.R.C. §§ 6110(a); 6104(a)(1).

[8] I.R.C. § 6104(a)(1), (d)(1).

[9] Evelyn Brody, *Sunshine and Shadows on Charity Governance: Public Disclosure as a Regulatory Tool*, 12 FLA. TAX. REV. 183, 217 (2012).

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available.[10] As a result, the Service started releasing these letters in 2004 with the identifying information of the applicants redacted.[11] These denial letters provide an important source of information about the criteria the Service uses to evaluate charitable organization exemption applications.

This project is the first of its kind. While others have commented on isolated denial letters,[12] this study is the first to conduct a comprehensive analysis of the Service denial letters issued from when they first became available in 2004 through January 31, 2017. In conducting this project, I examined 603 determination letters in which the Service denied exemption to an applicant seeking recognition as charitable organizations described in Section 501(c)(3). This project looks in-depth at the basis on which the Service denied exemption to these applicants.

To provide background for the basis of on which the Service reviews exemption applications for charitable applicants, Part I of this article describes the requirements to obtain exemption as a charitable organization described in Section 501(c)(3). In general, organizations described in Section 501(c)(3) must satisfy a five-part test: (i) the organizational test; (ii) the operational test; (iii) the prohibition on private inurement; (iv) the prohibition on political campaign intervention; and (v) the limitation on lobbying activity.[13] In addition, the Service imposes a global public policy limitation to deny exemption to organizations that technically may satisfy the five-part test but for which overriding public policy concerns prevent the Service from recognizing the organization as exempt.[14] The Service

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[10] Tax Analysts v. I.R.S., 350 F.3d 100, 104–05 (D.C. Cir. 2003) ("[T]he portions of Treasury regulations sections 301.6110-1(a) and 301.6104(a)-1(i) that include denials and revocations 'within the ambit of section 6104' and prevent their disclosure violate section 6110's plain language.").

[11] *See id.* at 104 ("[T]he Internal Revenue Service must disclose determinations denying or revoking tax exemptions, but do so in redacted form, thus protecting the privacy of the organizations involved.").

[12] *See, e.g.*, ADVISORY COMMITTEE ON TAX EXEMPT AND GOVERNMENT ENTITIES (ACT), THE APPROPRIATE ROLE OF THE INTERNAL REVENUE SERVICE WITH RESPECT TO TAX-EXEMPT ORGANIZATION GOOD GOVERNANCE ISSUES 3, 34–35 (June 11, 2008), http://www.irs.gov/pub/irs-tege/tege_act_rpt7.pdf; Brody, *supra* note 9, at 218–23; Benjamin Moses Leff, *Federal Regulation of Nonprofit Board Independence: Focus on Independent Stakeholders as a "Middle Way,"* 99 KY. L.J. 731, 780 (2011); James J. Fishman, *Stealth Preemption: The IRS's Nonprofit Corporate Governance Initiative*, 29 VA. TAX. REV. 545, 562–64 (2010).

[13] *See infra* nn.18–81 and accompanying text.

[14] *See infra* nn.82–90 and accompanying text.

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integrates the public policy limitation within the operational test in its analysis.

Next, I present the results of my study. In Part II of this article, I explain the methodology and the process by which I arrived at the data I present. Part III presents the data from my study and my analysis of the manner in which the Service applies the five-part test for exemption in its review of the applicants who were denied exemption. In evaluating the requirements identified in the Internal Revenue Code for Section 501(c)(3) organizations, I looked at the consistency with which the Service applied these requirements and the factors the Service considered in determining a particular requirement was not satisfied. The data pays particularly close attention to the evidence used by the Service to support its denial of tax-exempt status.

In Part IV of this article, I discuss the implications of my findings on the streamlined application process implemented by the Service in July 2014. The streamlined exemption application (Form 1023-EZ) is available for certain applicants that have assets of $250,000 or less and expected their annual gross revenues for the next three years not to exceed $50,000.[15] The streamlined exemption application is more efficient from the perspective of both the Service and the small charitable organizations applying for exemption which are eligible to use the form.[16] However, critics of the new streamlined application allege the Service has gone too far and has essentially abdicated its role in reviewing an applicant's qualifications for exemption with respect to the applicants that use the new streamlined procedures.[17] My

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[15] I.R.S. Instructions for Form 1023-EZ (Rev. Jan. 2017), https://www.irs.gov/pub/irs-pdf/i1023ez.pdf.

[16] *See* I.R.S. FORM 1023-EZ UPDATE REPORT, at 1–4, https://www.irs.gov/pub/irs-tege/form_1023ez_update_report_final.pdf (describing improved customer satisfaction and drastically reduced average processing times for issuing determination letters as a result of implementing the streamlined application process).

[17] *See* 1 NAT'L TAXPAYER ADVOCATE, *Form 1023-EZ: Recognition as a Tax Exempt Organization is Now Virtually Automatic for Most Applicants, Which Invites Noncompliance, Diverts Tax Dollars and Taxpayer Donations, and Harms Organizations Later Determined to Be Taxable*, *in* 2015 ANNUAL REPORT TO CONGRESS 36, at 44 [hereinafter NAT'L TAXPAYER ADVOCATE, *Form 1023-EZ*] ("By adopting Form 1023-EZ to address inventory backlogs, the IRS relinquished its power to effectively determine whether applicants qualify as IRC § 501(c)(3) organizations."). In its subsequent annual report, the National Taxpayer Advocate explains the ramifications to state regulators and the general public of the Service's reduced role in reviewing applicant's qualifications for tax exemption:

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data identifies concerns with the streamlined exemption process, and I suggest revisions that should be considered to the streamlined exemption process to make it more reliable.

I. Overview of Exemption Requirements

Section 501(c)(3) describes an exempt charitable organization as:

> Corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual, no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation (except as otherwise provided in subsection (h)), and which does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of (or in opposition to) any candidate for public office.[18]

This statutory definition results in a five-part test that an applicant must meet to qualify as an exempt charitable organization: (i) the organizational test; (ii) the operational test; (iii) the prohibition on private inurement; (iv) the prohibition on political campaign intervention; and (v) the limitation on lobbying activity. If an organization fails to meet any part of this five-part test, the organization may be denied exemption as a charitable organization. I note that the Treasury Regulations conflates the statutory five-part test into a two-part test consisting of an operational test and an organizational test.[19]

> Experience with Form 1023-EZ shows that a significant portion of approved Form 1023-EZ applicants do not qualify for IRC § 501(c)(3) status as a matter of law. In spite of this evidence, TE/GE has continued to rely on Form 1023-EZ and has chosen to substitute time-consuming audits for predetermination oversight. Moreover, by relinquishing its upfront leverage for achieving compliance via the determination letter process, the IRS has simply shifted the burden of consumer protection and verification downstream to states and donors. This has opened up a gap in which taxpayers and consumers are harmed.

MSP #19: FORM 1023-EZ, at 258. *See also* George K. Yin, *The IRS's Misuse of Scarce EO Compliance Resources*, 146 Tax Notes 267 (2015) (explaining the problems with streamlining the exemption determination process).

[18] I.R.C. § 501(c)(3).

[19] *See* Treas. Reg. § 1.501(c)(3)-1(a)(1) (2017).

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Under the structure of the Treasury Regulations, the operational test includes the prohibition on private inurement, the limitation on lobbying, and the prohibition on political campaign intervention within its confines.[20] The discussion of the basis for exemption in the determination letters I studied typically follows the definition of the operational test in the Treasury Regulations and thus conflates several distinct tests set forth in the statute into one overall test on operating for exempt purposes. By keeping consistent with the statutory structure in my analysis of these determination letters, I am able to identify the specific basis on which these five distinct tests were not satisfied in individual cases. I am also able to identify issues related to conflating these tests that may cause confusion in the application of these five tests and which have served as the basis for some criticism of the Service's evaluation of the applications which it has denied.

A. Organizational Test

The organizational test requires that the organization be organized for one or more of the enumerated charitable purposes listed in Section 501(c)(3), as determined by examining solely the articles of organization of the organization.[21] Accordingly, the purposes of the organization must be limited to one or more enumerated charitable purposes, and the governing documents may not allow the organization to engage in activities which are not charitable in nature.[22] Further, the organization's assets must be dedicated to a charitable exempt purpose. If, upon dissolution of the organization, its assets are permitted to be distributed to its members or for nonexempt purposes, the organization's assets are not dedicated to charitable exempt purpose.[23] Generally, the organization's governing documents must specifically direct that the assets be distributed for an exempt purpose upon

[20] *See* Treas. Reg. § 1.501(c)(3)-1(c) (2017).

[21] *See* Treas. Reg. § 1.501(c)(3)-1(b); Treas. Reg. § 1.501(c)(3)-1(b)(2) (An organization's "articles of organization" include "the trust instrument, the corporate charter, the articles of association, or any other written instrument by which an organization is created.").

[22] *See* Treas. Reg. § 1.501(c)(3)-1(b)(1)(i) and (iii). In addition, the articles of organization may not permit the organization to engage in more than insubstantial lobbying activities and may not allow the organization to intervene in any political campaign, advocating either for or against a candidate for public office. *See* Treas. Reg. § 1.501(c)(3)-1(b)(3).

[23] *See* Treas. Reg. § 1.501(c)(3)-1(b)(4).

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the organization's dissolution, unless applicable law of the jurisdiction in which the organization is formed requires this result.[24] Finally, an organization formed as a partnership or as a stock for-profit corporation will not satisfy the organizational test.

B. Operational Test

Although Section 501(c)(3) requires an organization to operate "exclusively" for exempt charitable purposes, the Treasury Regulations clarify that an organization satisfies the operational test if it engages primarily in activities which accomplish one or more of the enumerated exempt charitable purposes.[25] In other words, an organization may still satisfy the operational test if it engages in activity that does not further its exempt purpose, but such activity may not be more than an insubstantial part of its overall activities.[26] As part of the operational test, the Service applies a "commerciality" doctrine which examines whether the organization engages in nonexempt commercial activity to a substantial degree, and if so, the organization does not satisfy the operational test.[27] Another component of the operational test requires the organization to serve a public rather than a private interest. To satisfy this component, the organization may not operate in a way that benefits persons who are not part of the charitable class served by the organization to more than an insubstantial degree.[28] This limitation is known as the private benefit doctrine.

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[24] *Id.*

[25] *See* Treas. Reg. § 1.501(c)(3)-1(c)(1) ("An organization will be regarded as 'operated exclusively' for one or more exempt purposes only if it engages primarily in activities which accomplish one or more of such exempt purposes specified in section 501(c)(3).").

[26] *See id.*

[27] *See* Treas. Reg. § 1.501(c)(3)-1(e) (as amended in 2008) (providing that an organization "operated for the primary purpose of carrying on an unrelated trade or business is not exempt under section 501(c)(3).").

[28] *See, e.g.*, Rev. Rul. 76-206, 1976-1 C.B. 154 (organization supporting classical programming on a radio station provided a more than incidental private benefit to such radio station which was experiencing financial distress); Rev. Rul. 76-152, 1976-1 C.B. 151 (art gallery displaying and selling work of local artists provided substantial private benefit to local artists receiving a portion of the sales proceeds).

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1. No Substantial Commercial Activity

An organization fails to qualify for exemption as a charitable organization when the organization engages in substantial non-exempt commercial activity.[29] While a charitable organization is permitted to engage in an insubstantial amount of nonexempt activity, if an organization engages in too much unrelated business activity,[30] it risks the loss of its tax-exempt status as no longer satisfying the operational test.[31] There is no bright line rule with respect to how much unrelated business activity a charity may conduct without jeopardizing its tax-exempt status.

The Service uses two alternate tests to determine whether an exempt organization's unrelated business activity jeopardizes its exempt status: the commensurate in scope test and the primary purpose test. Under the commensurate in scope test an exempt organization may generate a significant amount of unrelated business income as long as the organization performs charitable programs that are commensurate in scope with its financial resources.[32] The determination hinges on whether the effort expended by the charitable organization to carry out its exempt activities is commensurate in scope with the organization's financial resources.[33] Under

[29] *See* Better Bus. Bureau v. United States, 326 U.S. 279 (1945) ("[T]he presence of a single non-[charitable] purpose, if substantial in nature, will destroy the exemption regardless of the number or importance of truly [charitable] purposes.").

[30] The term "unrelated trade or business" means an activity conducted by a tax-exempt organization which is regularly carried on for the production of income from the sale of goods or performance of services and which is not substantially related to the performance of the organization's charitable, educational or other exempt functions. *See* I.R.C. § 513(a).

[31] *See* Treas. Reg. § 1.501(c)(3)-1(e) (as amended in 2008) (stating that an organization may engage in commercial activity if such activity furthers the organization's exempt purpose or if such activity is not the primary activity of the organization).

[32] *See, e.g.*, Rev. Rul. 64-182, 1964-1 C.B. 186 (determining an organization which derived its income principally from rental of a large commercial office building was exempt when the organization provided assistance to other charitable organizations commensurate in scope with its financial resources); I.R.S. Priv. Ltr. Rul. 8042012 (July 3, 1980) (organization deriving income principally from the conduct of an insurance program for its members determined to be exempt because the organization made grants to other charitable organizations commensurate in scope with its financial resources). *But see* I.R.C. § 502(a) (prohibiting exemption for organizations primarily engaged in a trade or business activity simply because the organization dedicates its profits to one or more exempt charitable organizations).

[33] *See* I.R.S. Gen. Couns. Mem. 38742 (June 3, 1981). The Service explained the commensurate in scope test:

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the primary purpose test, if a substantial portion of a charitable organization's income or functions is comprised of unrelated business activities, the organization fails to qualify for exemption.[34]

While there are no bright line rules distinguishing when an organization's unrelated business activities have become too substantial to justify exemption,[35] the courts have identified factors to be used in determining whether the organization's activities are too commercial in nature for tax exemption. For example, in *Airlie Foundation v. Commissioner*,[36] the court relied on the commerciality doctrine in applying the operational test to determine that the organization operated for a commercial purpose rather than an exempt purpose. The court identified the factors relevant to its determination:

> The Service's position continues to be that an organization which is not engaged in religious, charitable, or educational activities but which distributes its income to organizations which are engaged in such activities may itself be exempt under section 501(c)(3) and furthermore may derive the bulk of its income from unrelated trade or business activities without jeopardizing its exempt status.
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> . . .
>
> With respect to commercial endeavors, the commensurate-in-scope test thus looks to the source of an organization's income for the limited purpose of determining the extent to which the organization is committed to the accomplishment of exempt purposes. If the facts show that the organization is carrying on a charitable program reasonably commensurate with its financial resources, including income from business activities, it cannot be said that the particular trade or business activity is being so conducted as to serve some nonexempt purpose.

Id.; *but see* Zagfly, Inc. v. Comm'r, 105 T.C.M. (CCH) 1214 (2013) (denying exemption to an internet flower broker which intended to operate a website through which customers could purchase flowers from a florist network and direct the profits from the transaction to a charity of the customer's choosing; the court was unpersuaded by the applicant's argument that its provision of financial assistance to other charities was commensurate in scope with the applicant's financial resources).

[34] *See* Piety, Inc. v. Comm'r, 82 T.C. 193 (1984) (holding that an organization contributing all of its profits from the conduct of bingo games to various charitable organizations was operated primarily for the purpose of carrying on a trade or business and thus, was not operated exclusively for an exempt purpose).

[35] *See* I.R.S. Gen. Couns. Mem. 38742 (June 3, 1981) ("[T]here is no quantitative limitation on the 'amount' of unrelated business an organization may engage in under section 501(c)(3), other than that implicit in the fundamental requirement of charity law that charity properties must be administered exclusively in the beneficial interest of the charitable purpose to which the property is dedicated").

[36] Airlie Found. v. I.R.S., 283 F. Supp. 2d 58 (D.D.C. 2003).

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> Among the major factors courts have considered in assessing commerciality are competition with for profit commercial entities; extent and degree of below cost services provided; pricing policies; and reasonableness of financial reserves. Additional factors include, inter alia, whether the organization uses commercial promotional methods (e.g. advertising) and the extent to which the organization receives charitable donations.[37]

Similarly, in *Living Faith Inc. v. Commissioner*,[38] the U.S. Court of Appeals for the Seventh Circuit identified the following factors in determining whether an organization operating vegetarian restaurants and health food stores consistent with the religious doctrines of the Seventh-day Adventist Church qualified as an exempt charitable organization:

> When undertaking this inquiry, we look to various objective indicia. The particular manner in which an organization's activities are conducted, the commercial hue of those activities, competition with commercial firms, and the existence and amount of annual or accumulated profits, are all relevant evidence in determining whether an organization has a substantial nonexempt purpose.[39]

In determining that Living Faith, Inc. operated for a substantial commercial purpose, and thus did not qualify for exemption, the court reasoned: (i) Living Faith sold goods and services to the public; (ii) the restaurants and health food stores operated by Living Faith were in direct competition with for profit businesses; (iii) the prices charged by Living Faith were based on pricing formulas common in the retail food businesses; (iv) Living Faith advertised its goods and services, employing promotional material and "commercial catch phrases" to enhance sales; and (v) Living Faith was not supported by charitable contributions.[40]

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[37] *See generally* B.S.W. Grp., Inc. v. Comm'r, 70 T.C. 352, 358 (1978) (holding that a corporation formed to provide consulting services did not satisfy the operational test because its activities constituted the conduct of a trade or business that is ordinarily carried on by commercial enterprises organized for profit. The court found that the organization's financing did not resemble that of a typical charitable organization. The organization had not solicited, nor had it received, voluntary contributions from the public. The organization's only source of income was from fees from services, and those fees were set high enough to recoup all projected costs and to produce a profit. Moreover, the organization never planned to charge a fee less than "cost." And finally, the organization did not limit its clientele to exempt charitable organizations).

[38] Living Faith, Inc. v. Comm'r, 950 F.2d 365 (7th Cir. 1991).

[39] *Id.* at 372.

[40] *Id.* at 376.

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2. No More than Incidental Private Benefit

The private benefit limitation is imposed to ensure that charitable organizations are operated for public purposes because of their special tax status.[41] As the private benefit doctrine has evolved, private benefit occurs when the organization confers a benefit upon a person who is not a member of the charitable class served by the organization.[42] A charitable class must be both indefinite and have charitable characteristics.[43] Indefinite means that the specific members comprising the class are not fixed.[44] Charitable characteristics, such as poor, distressed, underprivileged, sick, religious, educational and scientific, are analyzed qualitatively.[45] When the organization primarily serves the private interests of its members, the organization fails to qualify for exemption under the private benefit limitation even if the organization also conducts exempt purpose activities.[46]

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[41] John D. Colombo, *In Search of Private Benefit*, 58 FLA. L. REV. 1063, 1069 (2006); *see* Treas. Reg. § 1.501(c)(3)-1(d)(1)(ii) (as amended in 1990) (denying exemption to an organization unless it serves a public rather than a private interest. "Thus [] it is necessary for an organization to establish that it is not organized or operated for the benefit of private interests such as designated individuals, the creator or his family, shareholders of the organization, or persons controlled, directly or indirectly, by such private interests.").

[42] *See* John D. Colombo, *Reforming Internal Revenue Code Provisions on Commercial Activity by Charities*, 76 FORDHAM L. REV. 667, 681 (2007) ("Even trying to summarize the private benefit doctrine is hazardous, but from a variety of Service rulings and litigated cases, one might conclude that private benefit is a benefit (usually economic) that flows to some person or entity outside the charitable class as a result of serving the charitable class.").

[43] *See* Am. Campaign Acad. v. Comm'r, 92 T.C. 1053, 1076 (1989) (holding that the purported charitable class, the Republican party, was indefinite due to its large size, but lacked charitable characteristics).

[44] *Id.*

[45] *Id.* at 1076.

[46] *See generally* Capital Gymnastics Booster Club, Inc. v. Comm'r, 106 T.C.M. (CCH) 154, 2013 T.C.M. (RIA) 2013-193 (2013) (holding that a gymnastic booster club that allocated financial aid to support children engaged in amateur gymnastics competitions in proportion to the profit each child's family generated in conducting fundraising activities primarily served the private benefit of its members); Columbia Park and Recreation Ass'n, Inc. v. Comm'r, 88 T.C. 1 (1987) (concluding that an organization that developed and operated facilities and services for a private real estate development of 100,000 residents primarily benefitted private property owners and not the general public); Ginsberg v. Comm'r, 46 T.C. 47 (1966) (determining that a cooperative organization formed to dredge waterways primarily benefited adjacent property owners and any benefit to the general public was considered secondary); Rev.

Private benefit does not require the diversion of charitable assets.[47] If an applicant confers more than incidental private benefit, the Service may deny exemption for the organization.[48] The Service implements a "balancing test" to determine whether the private benefit is more than incidental:

> A private benefit is considered incidental only if it is incidental in both a qualitative and a quantitative sense. In order to be incidental in a qualitative sense, the benefit must be a necessary concomitant of the activity which benefits the public at large, i.e., the activity can be accomplished only by benefiting certain private individuals. To be incidental in a quantitative sense, the private benefit must not be substantial after considering the overall public benefit conferred by the activity.[49]

The private benefit doctrine is technically distinct from the prohibition on private inurement, and accordingly, is not limited to situations where benefits accrue to an organization's insiders.[50] The Service has been more willing to accept the contention that incidental private benefit, as opposed to incidental private inurement, will not preclude tax exemption.

C. No Private Inurement

Section 501(c)(3) provides that "no part of the net earnings of an organization described therein may inure to the benefit of any private shareholder or individual."[51] The Service asserts that any element of private inurement can cause an applicant to be denied exemption, and that there is

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Rul. 71-395, 1971-2 C.B. 228 (finding that a cooperative art gallery formed and operated by a group of artists for the purpose of exhibiting and selling their works does not qualify for exemption).

[47] I.R.S. Chief Couns. Adv. Mem. 2004-31-023 (July 13, 2004).

[48] For example, the Service ruled that an organization formed to promote interest in classical music was not exempt because its only method of achieving its goal was to support a commercial radio station that was in financial difficulty. Rev. Rul. 76-206, 1976-1 C.B. 154.

[49] I.R.S. Gen. Couns. Mem. 39,598 (Jan. 23, 1987) (citations omitted). The Service's balancing test was adopted by the Tax Court in *American Campaign Academy v. Commissioner*, 92 T.C. 1053 (1989).

[50] *See* Colombo, *supra* note 41, at 1067–69.

[51] I.R.C. § 501(c)(3). Although they are separate requirements, the "private inurement" test and the "operated exclusively for exempt purposes" test often overlap substantially. Western Catholic Church v. Comm'r, 73 T.C. 196 (6th Cir. 1979).

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no *de minimis* exception.[52] Private inurement contemplates a transaction between a charitable organization and its "insiders," persons who are able to cause the organization's assets to be used for private purposes because of the person's position.[53] Typically, members, directors, officers, founders and substantial contributors of the organization are considered insiders. Courts have adopted a pragmatic approach, rather than a literal construction of the term "net earnings" in the private inurement context.[54] While transactions between the organization and its insiders are not prohibited per se, other than for private foundations,[55] these transactions are considered suspect and scrutinized closely for reasonableness. Common transactions that may involve private inurement include (i) excessive compensation for services; (ii) inflated or unreasonable rental prices; (iii) certain loan arrangements involving the assets of a charitable organization; (iv) and purchases of assets for more than fair market value.[56]

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[52] I.R.S. Gen. Couns. Mem. 35,855 (June 17, 1974). The U.S. Tax Court has also adopted this approach. McGahen v. Comm'r, 76 T.C. 468, 482 (1981), *aff'd*, 720 F.2d 664 (3d Cir. 1983); Unitary Mission Church of Long Island v. Comm'r, 74 T.C. 507 (1980), *aff'd*, 647 F.2d 163 (2d Cir. 1981).

[53] *See* Treas. Reg. § 1.501(a)-1(c). *See, e.g.*, South Health Ass'n v. Comm'r, 71 T.C. 158, 188 (1978) (stating that the private inurement prohibition has generally been applied to an organization's founders or those in control of the organization).

[54] *See, e.g.*, Tex. Trade Sch. v. Comm'r, 30 T.C. 642 (1958) (holding that net earnings inured to insiders' benefit when the insiders leased property to an organization and caused it to make expensive improvements that would remain after the lease expired); Rev. Rul. 67-4, 1967-1 C.B. 123 (holding that an organization did not qualify for tax exemption because private inurement occurred when (i) the organization's principal asset was stock in the insiders' family-owned corporation, and (ii) the organization's trustees failed to vote against the corporation's issuance of a new class of preferred stock, diluting the organization's holdings); I.R.S. Tech. Adv. Mem. 91-30-002 (Mar. 19, 1991) (concluding that private inurement occurred when a hospital sold a facility to a private entity controlled by insiders for less than the fair market value).

[55] *See* I.R.C. § 4941 (generally prohibiting acts of "self-dealing" between a private foundation and its insiders).

[56] *See generally* Treas. Reg. § 53.4958-4 (as amended in 2002) (describing "excess benefit transactions" between a public charity and its insiders).

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D. Limitation on Lobbying Activity

A charitable organization may not engage in more than insubstantial lobbying activities or it will be deemed an "action" organization.[57] An "action" organization does not qualify for tax exemption as an organization described in Section 501(c)(3) of the Code.[58] Lobbying activities include: (i) contacting, or urging the public to contact, the common members of a legislative body for the purposes of proposing, supporting, or opposing legislation; or (ii) advocating the adoption or rejection of legislation.[59] For purposes of the limitation on lobbying activity, legislation is considered any action by the Congress, by any state legislature, by any local governing body or by the public in a referendum, initiative, constitutional amendment, or similar procedure.[60] A charitable organization may engage in nonpartisan analysis of legislation, even if the charity provides its analysis to the legislature, without being considered to be conducting lobbying activities.[61] If an organization's goals can only be accomplished through changes in legislation, it is denied tax exemption as an action organization even if the organization does not target any specific legislation.[62]

In applying the substantiality test to determine whether a charitable organization's lobbying activities comprise a substantial portion of the organization's overall activities, the Service considers (i) efforts of the organization's volunteers, (ii) the amount the organization spends on lobbying activity, (iii) other resources, such as office space or equipment,

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[57] *See* Treas. Reg. § 1.501(c)(3)-(1)(c)(3)(iv) (as amended in 2014) (describing an organization having a primary objective which can be attained only by legislation or defeat of proposed legislation and advocating for the attainment of its primary objective as opposed to engaging in nonpartisan analysis, study or research).

[58] Treas. Reg. § 1.501(c)(3)-(1)(c)(3)(i) (as amended in 2008).

[59] Treas. Reg. § 1.501(c)(3)-(1)(c)(3)(ii) (as amended in 2008).

[60] *Id.*

[61] *See* Treas. Reg. § 1.501(c)(3)-(1)(c)(3)(iv) (as amended in 2008); Rev. Rul. 64-195, 1964-2 C.B. 138 (finding that an organization's exempt status was not affected by its nonpartisan study, research and assembling of materials in connection with court reform and the dissemination of such materials to the public).

[62] *See* Christian Echoes Nat'l Ministry, Inc. v. United States, 470 F.2d 849 (10th Cir. 1972) (organization failed to qualify for exemption due to substantial lobbying activity even though no specific legislation was referenced by the organization).

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used by the organization for lobbying activity, and (iv) the amount of publicity spent on lobbying by the organization.[63] The Service may also consider the percentage of the organization's budget or employee time spent on lobbying activities, the continuous or intermittent nature of the organization's lobbying efforts, the nature of the organization and its goals, and the controversial nature of the organization's position and its visibility.[64]

The U.S. Court of Appeals for the Tenth Circuit applied the substantiality test of Section 501(c)(3) to uphold the Service's decision that a religious radio and television broadcast organization engaged in substantial lobbying activity.[65] Christian Echoes attempted to influence legislation by requesting that its readers write to their Congressional representative to support or oppose certain pieces of legislation. In applying the substantiality test, the Tenth Circuit determined that any form of a percentage test to measure the lobbying activities of an organization would obscure "the complexity of balancing the organization's activities in relation to its objectives and circumstances."[66]

Public charities that are concerned with meeting the substantiality test for lobbying activities may make an election under Section 501(h) of the Code to instead apply an "expenditure test" in measuring the amount of the organization's lobbying activities.[67] The vagueness of the facts and circumstances based "substantiality test" often prompts charitable organizations who engage in lobbying activities to elect the more mechanical and certain expenditure test. The expenditure test limits the dollar amount

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[63] I.R.S. Gen. Couns. Mem. 36148 (Jan. 28, 1975).

[64] *Id.*

[65] *Christian Echoes*, 470 F.2d 849.

[66] *Id.* at 855.

[67] *See* Treas. Reg. § 1.501(c)(3)-(1)(c)(3)(ii) (as amended in 2008). Section 501(h) provides a dollar limitation for direct and grassroots lobbying expenditures; compliance with this dollar limitation results in a determination that the organization is not engaged in substantial lobbying activity. *See* I.R.C. § 501(h)(1). Certain organizations may not make the expenditure test election in Section 501(h) including churches and private foundations. *See* I.R.C. § 501(h)(4), (5).

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that a public charity may spend on lobbying activities.[68] If the applicable dollar limitations are exceeded, an excise tax will generally apply.[69]

E. Prohibition on Political Campaign Activity

An exempt charitable organization may "not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of (or in opposition to) any candidate for public office."[70] As a result, an exempt charitable organization is strictly prohibited from participating in political campaign activities. In contrast to a charity's ability to lobby, the Code and Treasury Regulations do not allow even a *de minimis* amount of involvement in political campaign activities by charities.[71] If a charitable organization engages in impermissible political campaign

[68] *See* I.R.C. §§ 501(h)(1), 4911. In general, annual direct lobbying expenditures are limited to $1,000,000 but such limitation may be lower based on the electing organization's exempt purpose expenditures for the year. I.R.C. § 4911(c)(2). If the organization's exempt purpose expenditures are $500,000 or less, then the direct lobbying expenditures are limited to 20% of the organization's exempt purpose expenditures; if the organization's exempt purpose expenditures are more than $500,000 but less than or equal to $1,000,000, then the direct lobbying expenditures are limited to $100,000 plus 15% of the organization's exempt purpose expenditures in excess of $500,000; if the organization's exempt purpose expenditures are more than $1,000,000 but less than or equal to $1,500,000, then the direct lobbying expenditures are limited to $175,000 plus 10% of the organization's exempt purpose expenditures in excess of $1,000,000; and if the organization's exempt purpose expenditures are more than $1,500,000, then the direct lobbying expenditures are limited to $225,000 plus 5% of the organization's exempt purpose expenditures in excess of $1,500,000. *Id.* This limitation is known as the "lobbying nontaxable amount." *Id.* Expenditures for grassroots lobbying is limited to 25% of the organization's lobbying nontaxable amount. I.R.C. § 4911(c)(4).

[69] I.R.C. § 4911 (providing for an excise tax of 25% of excess lobbying expenditures applied to any electing organization that exceeds the applicable limitation on direct or grass roots lobbying in a taxable year). In addition, an electing organization that normally exceeds 150% of applicable limitations (measured over a four-year period) will lose its exempt charitable status. *See* I.R.C. § 501(h)(1), (2).

[70] I.R.C. § 501(c)(3). The Service takes a broad view of prohibited political campaign intervention. *See* Ellen P. Aprill, *Why the IRS Should Want to Develop Rules Regarding Charities and Politics*, 62 CASE W. RES. L. REV. 643, 645 (2012). For example, in Revenue Ruling 67–71, the Service determined that an organization formed to improve the public school system improperly engaged in political campaign activity when the organization evaluated the qualifications of candidates for the elected school board every four years and published a slate of candidates the organization deemed best qualified along with complete biographies of those candidates. Rev. Rul. 67–71, 1967-1 C.B. 125. The Service reasoned: "[T]he organization's activity in evaluating the qualifications of all potential candidates and then selecting and supporting a particular slate constitutes participation in a political campaign on behalf of particular candidates, even though its process of selection may have been completely objective and unbiased and was intended primarily to educate and inform the public about the candidates." *Id.*

[71] *See* I.R.C. § 501(c)(3); Treas. Reg. § 1.501(c)(3)-1(c)(3)(iv) (as amended in 2014).

activities, it is deemed an "action" organization.[72] In determining whether a charitable organization is an "action" organization, the Service considers all of the facts and circumstances.[73]

A person is considered a "candidate for public office" if he "offers himself, or is proposed by others, as a contestant for an elective public office, whether such office be national, state or local."[74] The Service may even consider a person a candidate for public office prior to the formal announcement of his or her candidacy.[75] However, the Service has decided that attempts to influence the Senate confirmation of a federal judicial nominee does not constitute impermissible political campaign activity.[76] The Service reasons that federal judges are appointed by the President and are not elected.[77]

Activities of charitable organizations which are prohibited include: (i) publication of printed statements on behalf of or in opposition to a candidate; (ii) distribution of written or printed statements on behalf of or in opposition to a candidate; (iii) making of oral statements on behalf of or in opposition to a candidate; (iv) distributing candidates' voting records and placing a "plus" or "minus" by each vote, depending upon whether the vote matches the views of the nonprofit; (v) distributing voter surveys presenting views of candidates on issues such as abortion and voluntary school prayer while reminding readers of its organization's beliefs and views; (vi) rating candidates based on various criteria such as their ability, experience and character; (vii) making cash contributions or "in kind" contributions of services or use of facilities to particular candidates or political parties; (viii) distributing a questionnaire to candidates and phrasing the questions which evidence bias on certain issues; (ix) compiling incumbents' voting records on a particular issue and distributing the material to the public;

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[72] Treas. Reg. § 1.501(c)(3)-1(c)(3)(iii) (as amended in 2014).

[73] *See* Rev. Rul. 2007-41, 2007-1 C.B. 1421.

[74] Treas. Reg. § 1.501(c)(3)-1(c)(3)(iii) (as amended in 2014).

[75] *See id.*

[76] I.R.S. Notice 88-76, 1988-2 C.B. 392. However, attempts to influence the Senate's confirmation of judicial nominees are considered lobbying activities by the organization. *Id.*

[77] *Id.*

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(x) conducting a public forum or debate and presenting questions that are biased toward the charitable organization's positions; and (xi) preparation of fund-raising letters which evidence bias towards certain candidates.[78]

Charitable organizations may take positions on public policy issues, including those that may divide candidates participating in an election for public office.[79] However, charitable organizations must avoid any issue advocacy that effectively functions as political campaign intervention.[80] The Service uses the following factors to determine whether a charitable organization's communication on public policy issues is permissible issue advocacy or improper political campaign intervention:

> [(a)] whether the statement identifies one or more candidates; [(b)] whether the statement expresses approval or disapproval for one or more candidates' positions and/or actions; [(c)] whether the statement is delivered close in time to an election; [(d)] whether the statement refers to voting or an election; [(e)] whether the issue raised distinguished one candidate from another; [(f)] whether the statement part of an ongoing series on the same issue by the organization made independent of the timing of the election; and [(g)] whether the timing of the communication and the identification of the candidate are related to a non-electoral event such as a scheduled vote on specific legislation regardless of the election.[81]

F. Public Policy Limitation

Under common law, charitable trusts are subject to the requirement that the purpose of the trust may not be illegal or contrary to public policy.[82] In

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[78] Revenue Ruling 2007-41, 2007-1 CB 1421. However, an organization may conduct voter education activities, such as the publication of voter education guides and presentation of public symposia, as long as such activities are carried out in a nonpartisan manner. *Id.* Further, providing a forum for a candidate for public office is permitted if the forum is not operated in a manner that reflects a bias or preference for or against such candidate. *Id.*

[79] *Id.*

[80] *Id.*

[81] *Id.*

[82] RESTATEMENT (SECOND) OF TRUSTS § 377 cmt. c (1959) ("A trust for a purpose the accomplishment of which is contrary to public policy, although not forbidden by law, is invalid."); *Id.* § 377 ("A trust is invalid if its purpose is illegal."); IV SCOTT ON TRUSTS § 377 (3d ed. 1967) ("A trust cannot be created for a purpose which is illegal. The purpose is illegal . . . if the trust tends to induce the commission of crime or if the accomplishment of the purpose is otherwise against public policy. . . . Where a policy is articulated in a statute making certain conduct a criminal offense, then . . . , a trust is illegal if its performance involves such criminal conduct, or if it tends to encourage such conduct.").

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the determination of whether an organization qualifies for exemption as a charitable organization described in Section 501(c)(3), the Service applies common notions of charity which effectively overlays the common law of charity across the specific five-part test identified in Section 501(c)(3) itself.[83] Accordingly, the Service may deny exemption to an applicant under the public policy doctrine if the organization's purposes or proposed activities are contrary to established public policy.

Perhaps the best-known application of the public policy limitation is to deny charitable exemption to schools which maintain racially discriminatory admissions or other policies. In *Bob Jones University v. United States*,[84] the Supreme Court upheld the Service's revocation of the tax exempt status of two religiously-affiliated schools because of their racially discriminatory policies. In reaching its decision, the Supreme Court explained that entitlement to tax exemption depends on meeting certain common law standards of charity—in particular, that an organization seeking charitable status must serve a public purpose and not be contrary to established public

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[83] *See* Rev. Rul. 71-447, 1971-2 C.B. 230. In Revenue Ruling 71-477, the Internal Revenue justified its imposition of a requirement that schools maintain a racial nondiscrimination policy for the admission of students to be exempt:

> Under common law, the term "charity" encompasses all three of the major categories identified separately under section 501(c)(3) of the Code as religious, educational, and charitable. Both the courts and the Service have long recognized that the statutory requirement of being "organized and operated exclusively for religious, charitable, * * * or educational purposes" was intended to express the basic common law concept. Thus, a school asserting a right to the benefits provided for in section 501(c)(3) of the Code as being organized and operated exclusively for educational purposes must be a common law charity in order to be exempt under that section.
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> . . .
>
> All charitable trusts, educational or otherwise, are subject to the requirement that the purpose of the trust may not be illegal or contrary to public policy. . . . Although the operation of private schools on a discriminatory basis is not prohibited by Federal statutory law, the policy of the United States is to discourage discrimination in such schools. The Federal policy against racial discrimination is well-settled in many areas of wide public interest . . . .

Id.; *see also* Treas. Reg. § 1.501(c)(3)-1(d)(2) (providing that the term "charitable" within the meaning of Section 501(c)(3) is applied in its generally accepted legal sense).

[84] 461 U.S. 574 (1982).

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policy.[85] The Supreme Court reasoned that it would be wholly incompatible with the concepts underlying tax exemption to grant exempt charitable status to an organization with purposes or policies contrary to established public policy, whatever may be the rationale of such organization.[86] Accordingly, the private school's racial discrimination in education was held contrary to public policy, even though the school alleged that its policy was grounded in the tenets of its religious beliefs.[87]

The Service also implements the public policy limitation to deny exemption to organizations that promote illegal activities to accomplish their exempt purposes. For example, in Revenue Ruling 75-384, the Service denied exemption to an organization formed to promote world peace and disarmament by educating and informing the public on the principles of pacifism.[88] The organization's primary activity was to sponsor antiwar protest demonstrations in which demonstrators were urged to violate local ordinances and commit acts of civil disobedience, such as blocking traffic and disrupting the work of government. The Service reasoned that by planning and organizing these events, the organization was encouraging the commission of criminal acts.[89] Accordingly, the organization's "activities demonstrate an illegal purpose which is inconsistent with charitable ends."[90]

II. METHODOLOGY

Tax Analysts, the publisher of *Tax Notes*, obtains redacted versions of all Service written determinations under a continuing Freedom of Information Act request. Tax Analysts then publishes these written determinations, typically weekly, in *Tax Notes Today*. To conduct this study, I searched the Tax Notes Today database[91] of Service written determinations

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[85] *Id.*

[86] *Id.*

[87] *Id.*

[88] Rev. Rul. 75-384, 1975-2 CB 204.

[89] *Id.*

[90] *Id.*

[91] The Service also makes exempt organization determination letters available on its website, but only as part of its general release of all written determinations. I.R.S. Written Determinations, http://www.irs.gov/app/picklist/list/writtenDeterminations.html. The Service database of written

for all determinations published between January 1, 2014 and January 31, 2017 involving "application for recognition of exemption from federal income tax" in which the applicant sought recognition as an organization described in Section 501(c)(3) but was denied.[92] To confirm that my database search yielded all available denial letters in the database, I also examined the daily table of contents of *Tax Notes Today* for written determinations involving the consideration of an application for exemption as an organization described in Section 501(c)(3). My search resulted in 603 available denial letters for the applicable time period. Of these denial letters, 15 did not include any explanation as to why the applicant's request for tax-exempt status was denied. Accordingly, I do not include these denial letters in my data set. After excluding these denial letters, the total data set of denial letters analyzed for this study was 588. In addition, I did not include written determinations explaining the rationale for revoking the exempt status of an organization already recognized as being exempt as an organization

determinations includes taxpayer specific rulings or determinations, technical advice memoranda and chief counsel advice materials. I.R.S. About IRS Written Determinations, https:// www.irs.gov/uac/about-irs-written-determinations. However, the Service database of over 58,000 written determinations is not searchable by key word; rather, the database can be sorted based on the ruling number, its release date, the subject matter of the ruling, or the Uniform Issue List Code (UILC) assigned to the ruling. The UILC is designed to index the key legal issues addressed in the ruling. However, UILCs are not helpful in singling out denial letters for applicants seeking exempt status as an organization described in Section 501(c)(3). *See* Brody, *supra* note 9, at 220 n.141 ("[T]he [determination] letters are coded in obscure and unhelpful ways . . . . Moreover, categorical assignments do not seem to be made with great care . . . [And] no single category is going to be helpful when the reasons for [denial] are manifold.").

[92] This study does not include any determinations in which an applicant sought tax-exempt status as an organization described in any other subsection of 501(c), including social welfare organizations described in Section 501(c)(4), labor and agricultural organizations described in Section 501(c)(5), business leagues described in Section 501(c)(6), and social clubs described in Section 501(c)(7). Section 501(c)(3) charitable organizations comprise substantially all of the types of tax-exempt organizations described in Section 501(c). At the end of fiscal year 2015, 1,548,948 tax-exempt organizations described in Section 501(c) were listed in the Service master database; 1,184,547 (or 76.4%) were charitable organizations described in Section 501(c)(3). I.R.S. DATA BOOK at 58 tbl.25 (2015). In addition, the exempt requirements for charitable organizations are vastly different than exemption requirements for other types of tax-exempt organizations, and each type of tax-exempt organization has unique determinants for exemption. Finally, the number of denials of applications for tax-exemption for other types of tax-exempt organizations is minimal, ranging from zero to twenty-two per year, and averaging less than eight per year, during the study period. *See* I.R.S. DATA BOOK at 57 tbl.24 (2015); I.R.S. DATA BOOK at 57 tbl.24 (2014); I.R.S. DATA BOOK at 55 tbl.24 (2013); I.R.S. DATA BOOK at 55 tbl.24 (2012); I.R.S. DATA BOOK at 55 tbl.24 (2011); I.R.S. DATA BOOK at 55 tbl.24 (2010); I.R.S. DATA BOOK at 55 tbl.24 (2009); I.R.S. DATA BOOK at 55 tbl.24 (2008); I.R.S. DATA BOOK at 53 tbl.24 (2007); I.R.S. DATA BOOK at 55 tbl.24 (2006); I.R.S. DATA BOOK at 39 tbl.21 (2005); and I.R.S. DATA BOOK at 38 tbl.21 (2004).

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described in Section 501(c)(3). These revocation letters will be the subject of my next study.

A. Disposition of Applications for Exemption

Each year, the Service receives tens of thousands of applications for recognition of exemption as a charitable organization.[93] The vast majority of these applications are approved.[94] Relatively few of these applications are denied exemption.[95] Some applications are disposed of without a ruling because the application is withdrawn by the applicant, the application contains incomplete information, or the Service refuses to rule on the application.[96] For these applications, the public disclosure requirement does not apply, and the Service is not required to make the application or the reasons why the application was not fully processed made publicly available.

Table 1 summarizes the disposal of all exemption applications by year, including for organizations seeking a determination related to exemption as charitable organizations.[97] The total applications include initial applications for tax-exempt status as well as other exempt organization determinations, such as advance approval of scholarship procedures for private foundations, determination of public charity status at the end of the advance determination period, and determination of exempt status for a related group of exempt organizations.[98]

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[93] *See, e.g.*, I.R.S. DATA BOOK at 57 tbl.24 (2014).

[94] *See id.*

[95] *See id.*

[96] *See, e.g.*, I.R.S. DATA BOOK at 57 tbl.24 n.2 (2014).

[97] Table 1 is derived from information provided in the IRS Data Book for the fiscal years ended September 30, 2004 through September 30, 2015. *See* I.R.S. DATA BOOK at 57 tbl.24 (2015); I.R.S. DATA BOOK at 57 tbl.24 (2014); I.R.S. DATA BOOK at 55 tbl.24 (2013); I.R.S. DATA BOOK at 55 tbl.24 (2012); I.R.S. DATA BOOK at 55 tbl.24 (2011); I.R.S. DATA BOOK at 55 tbl.24 (2010); I.R.S. DATA BOOK at 55 tbl.24 (2009); I.R.S. DATA BOOK at 55 tbl.24 (2008); I.R.S. DATA BOOK at 53 tbl.24 (2007); I.R.S. DATA BOOK at 55 tbl.24 (2006); I.R.S. DATA BOOK at 39 tbl.21 (2005); I.R.S. DATA BOOK at 38 tbl.21 (2004).

[98] *E.g.*, I.R.S. DATA BOOK at 57 tbl.24 n.1 (2014).

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Table 1

Disposition of 501(c)(3) Applications by Year

Fiscal Year Ended Sept. 30	Applications Approved	Applications Denied	Other Dispositions[99]	Total Dispositions[100]
2004	64,545	1,027	15,079	80,651
2005	63,402	765	13,372	77,539
2006	66,262	1,283	15,805	83,350
2007	66,278	1,607	15,886	85,771
2008	65,761	1,221	12,125	79,107
2009	56,943	472	13,209	70,624
2010	48,934	500	10,511	59,945
2011	49,677	205	5,437	55,319
2012	45,029	123	6,596	51,748
2013	37,946	79	7,264	45,289
2014	94,365[101]	67	5,600	100,032
2015	86,915[102]	57	5,681	92,653

Effective June 9, 2008, the Service eliminated the advance ruling requirement for public charities.[103] After the elimination of the advance

[99] "Other dispositions" consists of "applications withdrawn by organizations, applications that did not include the required information, incomplete applications, IRS refusals to rule on applications, IRS correction disposals, and others." *E.g.*, *id.* at 57, tbl.24 n.2 (2014).

[100] The total dispositions include initial applications for tax-exempt status as well as other exempt organization determinations, such as "public charity and private foundation status determinations, advance approval of scholarship grant procedures, and group determinations of tax-exempt status." *E.g.*, *id.* at 57 tbl.24 n.2 (2014).

[101] The dramatic increase in approved applications in fiscal year 2014 is due to the introduction of a streamlined exemption application (Form 1023-EZ) for smaller charitable organizations. *See* I.R.S. DATA BOOK at 57 tbl.24 (2014). It is important to note that the new Form 1023-EZ was not available until July 1, 2014. The Service received 9,533 1023-EZ applications in the final quarter of fiscal year 2014; 6,972 of these applications were closed in the same quarter, with 6,590 of the applications approved and none of the applications denied. *See* I.R.S. FORM 1023-EZ UPDATE REPORT, *supra* note 16, at 4 tbl.4. Three hundred and fifty-six of the applications were rejected, primarily due to ineligibility to use Form 1023-EZ or use of an invalid employer identification number (EIN) on the application. *Id.* at 4 tbl.4 and 5 tbl.5. Twenty-six applications were reported as "other closures" due to withdrawal of the application or duplicate application. *Id.* at 4 tbl.4. The introduction of Form 1023-EZ also allowed for the allocation of Service resources to clear a large backlog of exemption applications filed in prior years. *See* NAT'L TAXPAYER ADVOCATE, *Form 1023-EZ*, *supra* note 17, at 39.

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ruling requirement for public charities, the number of determination letters denying exempt status to applicants seeking recognition as exempt charitable organizations located for my study closely corresponds to the total number of denials of all types of exemption applications identified in Table 24 of the IRS Data Book. This suggests that many of the denials of all types of exemption applications prior to the elimination of the advance ruling requirement relates to Service determinations that an organization failed to meet the public support test at the end of its advance ruling period. It is important to note that this type of denial does not amount to a denial of exempt status as a charitable organization, but rather a reclassification of the exempt charitable organization from public charity to private foundation.[104]

The IRS Data Book does not separately report approval and denial information for only the initial applications seeking recognition of exempt status as charitable organizations. For point of reference, Table 1a sets forth the net increase or decrease in charitable organizations described in Section 501(c)(3) listed in the Service master database for each fiscal year in the study period and compares this net increase to the overall applications approved for all exempt organization determinations set forth in the IRS Data Book for the same fiscal year.

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[102] The Service received 44,872 1023-EZ applications in the fiscal year 2015; 46,212 applications were closed in fiscal year 2015, with 43,826 of the applications approved and none of the applications denied. *See* I.R.S. FORM 1023-EZ UPDATE REPORT, *supra* note 16, at 4 tbl.4. 2,092 of the applications were rejected, primarily due to ineligibility to use Form 1023-EZ or use of an invalid employer identification number (EIN) on the application. *Id.* at 4 tbl.4 and 5 tbl.5. 294 applications were reported as "other closures" due to withdrawal of the application or duplicate application. *Id.* at 4 tbl.4.

[103] *See* Treas. Reg. 1.509(a)-3(n) (as amended in 2011). Under the advance ruling requirement, an applicant seeking recognition as a public charity under Section 509(a)(1) or Section 509(a)(2) generally would receive a ruling to that effect that was effective for five years. The applicant would then need to submit a report evidencing that it satisfied the public support test before the end of its advance ruling period to establish that the organization qualifies as a public charity. If the organization failed to submit this report, or the public support test did not establish that the organization qualified as a public charity, then the organization would be reclassified as a private foundation.

[104] *See infra* nn.175–82 and accompanying text.

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Table 1a[105]

Net Increase in Charitable Organizations Per Year vs Overall Applications Approved Per IRS Data Book

Fiscal Year Ended Sept. 30	Charitable Organizations Beginning of Year	Charitable Organizations End of Year	Net Increase (Decrease) in Charitable Organizations[106]	Overall Applications Approved (IRS Data Book)
2004	964,418	1,010,365	45,947	64,545
2005	1,010,365	1,045,979	35,614	63,402
2006	1,045,979	1,064,191	18,212	66,262
2007	1,064,191	1,128,367	64,176	66,278
2008	1,128,367	1,186,915	58,548	65,761
2009	1,186,915	1,238,201	51,286	56,943
2010	1,238,201	1,280,739	42,538	48,934
2011	1,280,739	1,080,130	(200,609)[107]	49,677
2012	1,080,130	1,081,891	1,761	45,029
2013	1,081,891	1,052,495	(29,396)	37,946
2014	1,052,495	1,117,941	65,446	94,365
2015	1,117,941	1,184,547	66,606	86,915

The number of overall applications approved exceeds the net increase in charitable organizations for the same fiscal year for two reasons. First, the overall applications approved include approval of exempt organization

[105] The number of I.R.C. § 501(c)(3) organizations at the beginning and end of each fiscal year is derived from information provided in the IRS Data Book for the fiscal years ended September 30, 2003 through September 30, 2015. *See* I.R.S. DATA BOOK at 58 tbl.25 (2015); I.R.S. DATA BOOK at 58 tbl.25 (2014); I.R.S. DATA BOOK at 56 tbl.25 (2013); I.R.S. DATA BOOK at 56 tbl.25 (2012); I.R.S. DATA BOOK at 56 tbl.25 (2011); I.R.S. DATA BOOK at 56 tbl.25 (2010); I.R.S. DATA BOOK at 56 tbl.25 (2009); I.R.S. DATA BOOK at 56 tbl.25 (2008); I.R.S. DATA BOOK at 54 tbl.25 (2007); I.R.S. DATA BOOK at 55 tbl.25 (2006); I.R.S. DATA BOOK at 40 tbl.22 (2005); I.R.S. DATA BOOK at 39 tbl.22 (2004); and I.R.S. DATA BOOK at 30 tbl.22 (2003).

[106] Over this time period, the tax exempt status of approximately 905 organizations was revoked for reasons other than the automatic revocation of tax-exempt status for failure to file Form 990 series for three consecutive years. *See* I.R.S., Revocations of 501(c)(3) Determinations, https://www.irs.gov/charities-non-profits/charitable-organizations/revocations-of-501c3-determinations (data derived from IRS file for organizations issued a notice of revocation published between February 28, 2005 and August 24, 2015).

determinations in addition to initial applications for exemption, such as advance approval of scholarship procedures for private foundations, determination of public charity status at the end of the advance determination period, and determination of exempt status for a related group of exempt organizations. Second, the net increase in section 501(c)(3) organizations includes losses of organizations due to revocation of exempt status for existing organizations. The Pension Protection Act of 2006[108] implemented a new provision automatically revoking the exempt status of charitable organizations that do not file their required annual information return (Form 990 series) for three consecutive fiscal years.[109] Beginning in fiscal year 2011, the net increase or decrease in charitable organizations reflects a substantial number of organizations that failed to comply with this new requirement and as a result, were automatically determined to no longer qualify as charitable organizations.

As Table 1b illustrates, the percentage of applications that are denied range from less than 0.1% to approximately 1.9% of the total applications closed during the year. The total applications closed in a given year includes as part of "other dispositions" applications which are incomplete or which are withdrawn by the applicant. If the number of "other dispositions" is subtracted from the total, then the percentage of applications that are denied range from less than 0.1% to just over 2.3% of the total applications approved or denied. Further, the percentage of applications that are denied markedly decreased since fiscal year 2008,[110] and even more so with the introduction

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[107] The exempt status of over 385,000 organizations was revoked in fiscal year 2011 due to failure to file Form 990 series for three consecutive years. I.R.S. DATA BOOK at 56 tbl.25 n.1 (2011).

[108] Pension Protection Act of 2006, Pub. L. No. 109-280, 120 Stat. 780 (codified as amended in scattered sections of 26 and 29 U.S.C.).

[109] I.R.C. § 6033(j)(1).

[110] Effective June 9, 2008, the Service eliminated the advance ruling requirement for public charities. *See* Treas. Reg. § 1.509(a)-3(n). Under the advance ruling requirement, an applicant seeking recognition as a public charity under Section 509(a)(1) or Section 509(a)(2) generally would receive a ruling to that effect that was effective for five years. The applicant would then need to submit a public support report before the end of its advance ruling period to establish that the organization qualifies as a public charity. If the organization failed to submit this public support test, or the public support test did not establish that the organization qualified as a public charity, then the organization would be reclassified as a private foundation. The elimination of the advance ruling requirement, and the corresponding elimination of the need to rule on whether an organization satisfied the public support test, may account for a portion of the decrease in overall dispositions resulting in denials.

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of the streamlined application for exemption (Form 1023-EZ) in fiscal year 2014.[111]

Table 1b

Percentage of 501(c)(3) Applications Resulting in Denial by Year

Fiscal Year Ended Sept. 30	Applications Denied (IRS Data Book) [112]	Total Dispositions[113]	*Percentage of Total Dispositions Denied*	Total Applications Approved and Denied[114]	*Percentage of Total Approved /Denied Applications Denied*
2004	1,027	80,651	*1.27%*	65,572	*1.57%*
2005	765	77,539	*0.99%*	64,167	*1.19%*
2006	1,283	83,350	*1.54%*	67,545	*1.90%*
2007	1,607	85,771	*1.87%*	68,885	*2.33%*
2008	1,221	79,107	*1.54%*	66,982	*1.82%*
2009	472	70,624	*0.67%*	57,415	*0.82%*
2010	500	59,945	*0.83%*	49,434	*1.01%*
2011	205	55,319	*0.37%*	49,882	*0.41%*
2012	123	51,748	*0.24%*	45,152	*0.27%*
2013	79	45,289	*0.17%*	38,025	*0.21%*
2014	67	100,032	*0.07%*	94,432	*0.07%*
2015	57	92,653	*0.06%*	86,972	*0.07%*

[111] *See infra* nn.183–225 and accompanying text for a discussion of the Form 1023-EZ requirements and its implications for the application process.

[112] Only five of the 87,157 Form 1023-EZ applications closed from July 1, 2014 through June 24, 2016 resulted in denials of the application. I.R.S. FORM 1023-EZ UPDATE REPORT, *supra* note 16, at 4 tbl.4. None of these denials were issued in fiscal year 2014 or fiscal year 2015 and therefore are not reflected in the applications denied. *See id.* Through December 31, 2016, the Service has approved more than 105,000 Form 1023-EZ applications. *See* IRS News Release 2017-41 (Feb. 22, 2017), https://www.irs.gov/ uac/newsroom/irs-makes-approved-form-1023ez-data-available-online. Between July 1, 2014 and December 31, 2016, six denial letters for applicants using Form 1023-EZ have been released. *See* I.R.S. Priv. Ltr. Rul. 2016-41-026 (July 14, 2016); I.R.S. Priv. Ltr. Rul. 2016-36-046 (June 6, 2016); I.R.S. Priv. Ltr. Rul. 2016-32-023 (May 11, 2016); I.R.S. Priv. Ltr. Rul. 2016-32-020 (May 11, 2016); I.R.S. Priv. Ltr. Rul. 2016-31-014 (May 5, 2016); I.R.S. Priv. Ltr. Rul. 2016-14-038 (Jan. 4, 2016).

[113] The total dispositions include initial applications for tax-exempt status as well as other exempt organization determinations, such as "public charity and private foundation status determinations, group determinations of tax-exempt status, and advance approval of scholarship grant procedures." *E.g.*, I.R.S. DATA BOOK at 57 tbl.24 n.1 (2014).

[114] The total applications approved or denied is the difference between the "total dispositions" and the "other dispositions" reported for the applicable fiscal year in the applicable IRS Data Book, Table 24. Other dispositions consist of "applications withdrawn by organizations, applications that did not include the required information, incomplete applications, IRS refusals to rule on applications, IRS correction disposals, and others." *E.g.*, I.R.S. DATA BOOK at 57 tbl.24 n.2 (2014).

B. Criteria for Evaluation

In conducting this study, I categorized the Service basis for denial using the five-part test for recognition of exemption as an organization described in Section 501(c)(3): the operational test; the organizational test; the prohibition on private inurement; the limit on lobbying activity; and the prohibition on political campaign intervention. Within the operational test, I also categorized the factors considered by the Service in making its determination, with the main factors being failure to state an exempt purpose, inclusion of provisions that impermissibly broaden the exempt purpose or activities, failure to include an appropriate dissolution provision, and selection of a form of organization inconsistent with an exempt charitable organization. Within the operational test, I categorized major factors considered by the Service in making its determination: failure to conduct activities consistent with an exempt purpose, other than commercial activities; conduct of substantial commercial activities; provision of substantial private benefit; and conduct of activities in violation of the public policy limitation. For the commerciality aspect, I also categorized the major factors the Service identified in its determination that the applicant engaged in substantial commercial activity. Within the context of private inurement, I categorized types of transactions the Service identified as resulting in impermissible private inurement and identified instances in which no proposed transactions between the organization's insiders and the organization were identified. I also focused on the factors relating to governance of the organization that the Service identified as relevant to its determination that impermissible private inurement was present. Finally, I categorized each applicant's stated exempt purpose, desired status as a public charity or private foundation, and potential qualification to use the streamlined application form, Form 1023-EZ. Within each category, each factor was classified with a binary "yes" or "no." The results provide the total for each category and an explanation of the relevance of these totals.

C. Caveats

Due to the nature of this study, I cannot report correlations between the various factors considered by the Service and the satisfaction of one or more tests for exemption. First, the study examines only applications that have been denied. As Table 1 and Table 1b report, the number of applications which are denied is a very small subset of all exemption applications closed over the applicable time period of my study. The denial letters are not a

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representative sample of all applications closed and were selected for the study due to their fact specific nature. To assess any correlation between a particular factor, for example independence of the organization's board of directors, and satisfaction of the prohibition on private inurement, one would also need a statistically significant sampling of applications that were approved. Gathering information from such applications is a tedious process requiring the researcher to request the exemption applications identified in the sample and Internal Revenue correspondence relating to those applications from the Service or the organizations themselves.

Further, each application is evaluated on its own merits. Structuring an organization similar to organizations in which the Service had previously determined to be exempt does not guarantee a determination of exemption. For example, in one ruling in which the applicant was denied exempt status, the applicant claimed that it patterned its organization after organizations that were already exempt, and the applicant would provide names of those organizations to "justify receiving exemption as a similar organization."[115] The Service responded that it considers the facts and circumstances of each applicant individually, and thus, "[q]ualification of another entity is not a basis for a similar ruling."[116] Moreover, some applicants were previously recognized as exempt charitable organizations but their exemptions were automatically revoked due to the organizations' failure to file an annual information return for three consecutive years.[117] However, the Service was not persuaded to approve an applicant's exemption application when the applicant claimed its activities were the same as those previously approved by the Service as qualifying for tax-exempt status.[118]

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[115] I.R.S. Priv. Ltr. Rul. 2015-16-066 (Jan. 21, 2015).

[116] *Id.*; *see* Priv. Ltr. Rul. 2016-15-017 (Jan. 16, 2016) (Service rejected applicant's comparison to an existing exempt organization); Priv. Ltr. Rul. 2014-04-013 (Oct. 29, 2013) (organization identified three examples of other exempt organizations conducting similar activities but the Service rejected the comparison). Presumably, the Service is referencing the restriction in Section 6110(k)(3) which provides that generally, "a written determination may not be used or cited as precedent." I.R.C. § 6110(k)(3). However, this limitation does not apply to Revenue Rulings, and the Service routinely relies on Revenue Rulings and cases in comparing and distinguishing activities of an applicant to those of similar organizations who have been granted or denied exempt status in published Revenue Rulings and cases.

[117] *See* I.R.C. § 6033(j)(1). A total of eight applicants in my data set were previously recognized as exempt charitable organizations by the Service.

[118] *See* I.R.S. Priv. Ltr. Rul. 2016-15-017 (Jan. 16, 2016); I.R.S. Priv. Ltr. Rul. 2014-07-015 (Nov. 19, 2013).

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Finally, identifying information in the denial letters are redacted, and in some cases the substance underlying redaction is difficult to determine. In redacting identifying information, the Service makes no effort to give a sense of scale or proportion that may evidence the materiality of the problem. For example, the Service may report that the revenue the organization receives from the conduct of a trade or business of "$x" or "$ * * *" but the reader cannot determine whether such amount is material and must rely on the Service's assessment of the matter. As a result, it is difficult to assess whether the Service was justified in denying exemption to applicants when the redacted information is essential for the determination of whether an applicant satisfies the requirements of one of the five tests for exemption. Accordingly, I do not purport to determine whether the Service correctly determined that an applicant did not qualify for tax exemption.

Rather, the purpose of this study is to identify the areas in which applicants most often do not satisfy the requirements for exemption. While much of these requirements can be ascertained from statutory and regulatory law, published Service guidance on which taxpayers may rely and reported cases, there are instances in which the Service's positions on tax-exemption qualifications are set forth only in private rulings such as the denial letters examined in this study. This study aims to highlight those areas as well and identify the frequency with which the Service uses these positions as a justification for denial of tax-exempt status.

III. Empirical Findings

A. Organizational Test, Operational Test and Violation of Private Inurement Prohibition are the Primary Basis for Denials

Of the data set of 588 denial letters examined, 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. As Table 2 illustrates, 535 of applicants in the data set were denied on the basis of failing to meet the operational test, 290 were denied on the basis of engaging in impermissible private inurement, 183 were denied on the basis of failing to meet the organizational test, 9 were denied on the basis of engaging in substantial lobbying activity, and 4 were denied on the basis of engaging in political campaign intervention. In many of the denial letters, the Service cited multiple reasons why a particular applicant did not satisfy the five-part test for exemption. Accordingly, a particular

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denial letter in the data set may be counted more than once in Table 2 because the Service cited more than one violation of the five-part test for exemption.

Table 2

Number of Applicants in Data Set Denied Based on the Five Major Tests for Exemption

Test for Exemption	Number of Applicants in Data Set Failing to Meet Test	Percentage of Applicants in Data Set (Total Data Set = 588)
Organizational Test	183	31.1%
Operational Test	535	91.0%
Prohibition on Private Inurement	290	49.3%
Limitation on Lobbying Activity	9	1.5%
Prohibition on Political Campaign Intervention	4	0.7%

1. Basis for Failure to Meet the Organizational Test

Table 3 sets forth the factors identified by the Service in determining that an applicant in the data set did not satisfy the organizational test. From the organizational documents of the applicant, the Service must be able to determine that the organization is established for exempt purposes described in Section 501(c)(3), the organization is not permitted to engage in activities that would accomplish purposes other than the organization's exempt purpose, upon dissolution of the organization, the organization's assets will be dedicated to exempt purposes, and the organization is not formed as a for-profit stock corporation or partnership which, by virtue of its form, would allow for the distribution of earnings to its shareholders or partners.[119] In many of the denial letters in which the organizational test was not satisfied, the Service cited multiple reasons why a particular applicant did not satisfy the test. Accordingly, a particular denial letter in the data set may be counted more than once in Table 3 because the Service cited more than one factor as

[119] Treas. Reg. § 1.501(c)(3)-1.

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the basis for its determination that the applicant did not meet the requirements of the organizational test.

Table 3

Basis Identified for Failure to Meet the Organizational Test

Basis Identified for Failure to Satisfy Organizational Test	Number of Applicants in Data Set	Percentage of Applicants in Data Set (Total Data Set = 183)
Organizational documents did not contain a purpose recognized as an exempt purpose described in Section 501(c)(3)	102	55.7%
Organizational documents permitted applicant to engage in activities that would accomplish purposes other than the organization's exempt purpose	57	31.1%
Organizational documents lacked required dissolution clause or dissolution clause permitted distribution for nonexempt purpose	51	27.9%
Choice of organizational form inconsistent with exempt charitable organization	21	11.5%

The articles of organization of 61 (or 33.3%) of the applicants who failed to satisfy the organizational test[120] contained improper provisions which easily could be remedied with the filing of amended articles of organization correcting the improper provisions. These improper provisions include catchall purposes or activities clauses which allow the applicant to

[120] This number includes only applicants that submitted organizational documents that permitted the organization to engage in nonexempt activities or that did not include a proper dissolution clause but otherwise included a recognized exempt purpose.

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engage in any lawful purpose or any lawful activity and failure to include the required dissolution clause. For example, an organization failed to meet the operational test when its articles of incorporation stated the organization's purposes were "for receiving and administering funds for perpetuation of the memory of B and for educational and charitable purposes, *along with any other provision allowable under the law*."[121] The Service determined the applicant failed the organizational test because its articles of organization permitted it to accomplish any lawful nonprofit purpose, which is more expansive than the enumerated exempt purposes in section 501(c)(3). In other instances, an organization failed to meet the operational test because its articles of organization did not contain the requisite dissolution clause, and applicable state law did not limit the distribution of the applicant's assets on dissolution for use only in exempt purposes. For example, an organization's dissolution clause was not sufficient to satisfy the organizational test when it provided that upon dissolution of the organization, the assets would be distributed to "another non profit agency with similar mission."[122] The Service reasoned that such a broad statement did not ensure the organization's assets will be dedicated to charitable purposes upon the organization's dissolution because the recipient organization was not limited to an exempt charitable organization.[123] This type of violation would be easily remedied by filing amended articles of organization which contain the required dissolution clause.

In all situations in which the applicant failed to meet the organizational test, the applicant also failed to meet the operational test. This suggests that the Service does not deny exemption solely on the basis of a technical violation of the organizational test. For example, to satisfy the organizational test, the applicant's articles of organization must contain a dissolution clause which directs that the applicant's assets will be distributed for exempt purposes upon its dissolution, or such provision must be established by applicable state law. If an applicant's articles of organization fail to contain this required provision but the applicant's proposed activities otherwise meet the operational test, the Service likely will ask the applicant to amend its

[121] I.R.S. Priv. Ltr. Rul. 2015-02-017 (Oct. 14, 2015).

[122] *See* I.R.S. Priv. Ltr. Rul. 2015-10-058 (Dec. 11, 2014).

[123] *Id.*

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articles of organization to include the required dissolution clause instead of denying the application outright.[124] Assuming the applicant amends its articles of organization as directed, the Service likely will grant the application for exemption.[125]

2. Proposed Substantial Lobbying Activity was not Evident to a Significant Degree

On the whole, proposed substantial lobbying activity was not evident in a significant number of the denial letters examined in the study. Nine of the applicants in the data set of 588 denial letters (or 1.5%) were denied charitable status on the basis of the applicant engaging in more than insubstantial lobbying activity. It is likely that charitable organizations which desire to engage in lobbying activities indicate on their applications that they will elect to be measured on the "expenditure test" set forth in Internal Revenue Code section 501(h) and provide evidence of satisfaction of that test.[126] Three of the applicants were denied exempt status due to substantial lobbying activity that indicated an intent to make the section 501(h) election.[127]

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[124] *See* NAT'L TAXPAYER ADVOCATE, *Form 1023-EZ*, *supra* note 17, at 39 ("[I]f the articles of incorporation do not meet the organizational test, but the applicant appears to otherwise qualify for favorable determination and no other organizing document issues need to be addressed, the [IRS] agent merely asks the applicant to attest that the articles have been amended to correct the deficiency.").

[125] Under streamlined procedures adopted in January 2014 for processing exemption applications, the Service will issue a favorable determination letter if the organization has an organizational test deficiency and attests to the Service that the organization will amend its organizing documents to correct the deficiency. *See id.* The National Taxpayer Advocate notes this attestation process does not ensure the organization will amend its organizing documents as required to qualify for tax exemption. *See id.* at 40 ("[The IRS] could have required a copy of the amended articles after its initial review in the application phase, making certain, while it had the organizations' attention and leverage over them, that they met the organizational test. Instead, the IRS substituted an exchange of correspondence (and issued a favorable determination letter) for actual oversight of organizations it knew were not compliant.").

[126] *See supra* nn.67–69 and accompanying text.

[127] Despite making the section 501(h) election, the organizations were denied exempt status as the Service determined lobbying was a substantial part of the organization's proposed activities. One organization established that 5% to 10% of its expenditures would be attributable to attempting to influence legislation on social justice issues and filed a section 501(h) election. I.R.S. Priv. Ltr. Rul. 2014-08-030 (Nov. 27, 2013). However, the Service determined the organization's lobbying activities to be substantial because its expenditures did not include "time devoted to gathering the information for the specific purpose of use in the effort to influence legislation, as well as activities such as visiting homes,

In almost all of the denial letters in which the Service determined the applicant engaged in substantial lobbying, the applicant had not identified any particular proposed or pending legislation that the applicant intended to influence. However, the Service determined that the only way the applicant could accomplish its purposes was to engage in lobbying activity to attempt to change existing law.

For example, the Service denied exemption to an organization formed to "raise awareness of how technology can be employed to improve governance local, state, federal levels."[128] The organization planned to educate people on how government can employ technology to be more transparent and accountable with the goal of eventually requiring "states and cities to post all of their expenses online."[129] In addition, the organization wanted politicians to work and live only in their respective home districts and advocated for the use of technology such as video conferencing and the Internet to make this goal a reality. Even though the organization claimed it was nonpartisan and had no intention of lobbying lawmakers, the Service found the organization's primary activity to be "advocating for the adoption of a particular doctrine or theory . . . which can become effective only by the enactment of legislation."[130] The Service reasoned that the only way to accomplish the organization's stated goal was for legislative bodies to change their internal rules, and because these legislative bodies would have to undertake action to change their internal rules and the organization urged the public to encourage legislative bodies to change their internal rules, the organization was influencing legislation.[131]

The organization countered that it did not propose any specific measures for legislative bodies to adopt and that the organization's goal was to educate the public of the possibility for legislators to work from their home districts instead of relocating to state capitals or Washington, D.C. However, the

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developing legislative action teams and identifying a 'legislative director' to facilitate communication with elected officials." *Id.*

[128] I.R.S. Priv. Ltr. Rul. 2015-05-042 (Nov. 6, 2014).

[129] *Id.*

[130] *Id.*

[131] *Id.*; *see also* Treas. Reg. § 1.501(c)(3)-1(c)(3)(ii).

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Service found the organization to be analogous to *Christian Echoes National Ministry*:

> The Court also noted the fact that specific legislation was not mentioned does not mean that their attempts to influence public opinion were not attempts to influence legislation. You appeal to the public to adopt your goal of changing how legislative bodies operate. As such, you are similar to *Christian Echoes National Ministry* insomuch that the Court noted an essential part of the organization's activities was to promote desirable governmental policies consistent with its objectives through legislation.[132]

While the Service conceded an educational component comprised a portion of the organization's activities,[133] the Service was most persuaded by the organization's desire to change the status quo, and that change could only be accomplished through legislation.

3. Proposed Political Campaign Intervention was not Evident to a Substantial Degree

On the whole, proposed political campaign intervention was not evident in a significant number of the denial letters examined in the study. Four applicants in the data set of 554 denial letters (or 0.7%) were denied charitable status on the basis of the applicant engaging in prohibited political campaign activity. In almost all of these denial letters, the applicants contended that their activities were educational in nature and were not intended to advocate for or oppose any candidate for public office. However, the Service was unpersuaded due to the partisan nature of the applicants' activities.

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[132] I.R.S. Priv. Ltr. Rul. 2015-05-042 (Nov. 6, 2014).

[133] The Service also distinguished the organization from organizations found to be exempt in Revenue Ruling 64-195, 1964-2 C.B. 138 and Revenue Ruling 78-305, 1978-2 C.B. 172:

> Revenue Ruling 64-195 describes an organization that was granted exemption under section 501(c)(3) for providing nonpartisan study, research and assembly of materials regarding court reform. The information included both pro-reform and anti-reform materials. Revenue Ruling 78-305 describes an organization granted exemption under section 501(c)(3). The organization disseminated information with a full and fair exposition of the facts that allowed the public to form an independent conclusion. You operate unlike both organizations in that by promoting your conclusion you do not present a full and fair exposition of the facts.

Id.

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In one representative example, the Service determined that an organization formed to "create symposiums as a national, educational convention of E thinkers, statesmen and opinion leaders" related to a particular political ideology failed to qualify for exemption because the organization "spend[s] a substantial amount of time and resources devoted to activities that are typical of an action organization."[134] The organization planned to hold a symposium in its state open to the general public at the start of the 2012 election season. The organization promoted the event as an opportunity to "offer a platform to key E leaders in state and national government to share their views with those assembled" and desired those attending the event to "prepare a set of documents reflecting their perspective which will then be shared with political leaders as the election season unfolds."[135] Importantly, only leaders and speakers sharing the same political ideology of the organization's founders and belonging to the political party advancing such political ideology were invited to speak at the event. Further, many of the invited speakers currently were engaged in campaigns for political offices, and the event sponsored "Meet the Candidate" sessions where attendees presumably would be able to converse with these candidates for public office. The organization emphasized that while elected officials and candidates for office would be invited to speak at the event, such speeches would be for educational purposes only and the symposia presented by the organization would not be political fundraising events. Rather, the organization viewed its event as "an educational forum to assist citizens in becoming more effective advocates, focusing on the Constitution and founding principles, policy, economy, education, health and values."[136]

The Service was not persuaded. Importantly, the Service focused on the applicant's partisan selection of speakers for its event:

> In determining if your activities constitute political campaign intervention we considered whether you are distinguishing a candidate, excluding a candidate, or lacking neutrality in allowing candidates to participate. Your intent was to hold a symposium inviting only [political party] F candidates or current positioned [political party] F politicians, promote those speakers through the symposium, and

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[134] I.R.S. Priv. Ltr. Rul. 2015-23-021 (Mar. 13, 2015).

[135] *Id.*

[136] *Id.*

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> do so at a time prominent during a campaign season (before a presidential primary). In focusing on only one political party you lack neutrality, exclude candidates and distinguish those focused at your event. Even though [your event] was eventually cancelled your only activity since formation had been planning [this event]. This clearly shows your purpose was to support and further the interests of candidates of the F [political] party.[137]

The Service clarified that inviting candidates to participate in a forum of speakers is not improper political campaign intervention provided candidates of opposing political parties are given an equivalent opportunity to participate. Since the applicant invited speakers from only one political party to speak at its event, the Service determined the applicant's activities constituted political campaign intervention.[138]

B. Basis for Failure to Meet the Operational Test

Table 4 sets forth the factors identified by the Service in determining that an applicant in the data set did not satisfy the operational test. Even if the organizational test is satisfied, the Service must be able to determine from the information supplied by the applicant that the organization will be operated for exempt purposes described in Section 501(c)(3). In doing so, the Service examines the applicant's proposed activities in relation to the specific tests identified for the type of exempt activity in which the applicant proposes to engage. Additionally, if the organization engages in commercial business activity or confers substantial private benefit, the organization will fail to meet the requirements of the operational test as having a substantial nonexempt purpose. Finally, the Service considers the public policy limitation in its analysis of an applicant's satisfaction of the operational test. Violation of the public policy limitation will cause the applicant to fail the operational test even though other aspects of the operational test are satisfied. In many of the denial letters in which the operational test was not satisfied,

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[137] *Id.*

[138] *Id.* The Service explained:

> Political campaign intervention includes any and all activities that favor or oppose one or more candidates for public office. The prohibition extends beyond candidate endorsements. Allowing a candidate to use an organization's assets or facilities also constitutes political campaign intervention if other candidates are not given an equivalent opportunity. . . . While inviting candidates to participate is not in itself campaign intervention, inviting only one particular party of candidates is.

Id. See also Rev. Rul. 2007-41, 2007-25 I.R.B. 1421.

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the Service cited multiple reasons why a particular applicant did not satisfy the test. Accordingly, a particular denial letter in the data set may be counted more than once in Table 4 because the Service cited more than one factor as the basis for its determination that the applicant did not meet the requirements of the operational test.

Table 4

Basis for Failure to Meet the Operational Test

Rationale for Failure to Meet the Operational Test	Number of Applicants in Data Set	Percentage of Applicants in Data Set (Total Data Set = 535)
Organization's proposed activity did not satisfy applicable specific test for exemption for the type or of activity conducted by the organization	184	34.4%
Organization conferred more than insubstantial private benefit	283	52.9%
Organization engaged in substantial commercial activity	268	50.1%
Organization's activities violated the public policy limitation	13	2.4%

The most common reasons cited for failure to meet the operational test are the organization conferring more than insubstantial private benefit, and the organization engaging in substantial commercial activity not in furtherance of its exempt purposes. For most organizations, the Service cited two or more reasons why the applicant failed to meet the organizational test.

1. Proposed Activity Not "Charitable"

Determinations that an organization did not operate for permissible charitable purposes were highly individualized and often hinged on the Service's distinctions between the applicant's proposed activities and published cases and rulings determining similar activities to satisfy the operational test and analogies to published cases and rulings determining

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activities similar to the applicant's activities did not satisfy the operational test. Many of these rulings involved consideration of whether the organization's activities were "educational" within the meaning of Section 501(c)(3), and to a lesser extent, whether the organization's activities served to promote health, qualified as "scientific" or lessened the burdens of government. Organizations purporting to operate for the "relief of poverty" often did not limit benefits of its operations to a charitable class, and thus were denied exemption on the basis of providing substantial private benefit, as discussed below.

2. Commerciality Doctrine

When the Service determined that an applicant is engaged in substantial commercial activity, the Service used the primary purpose test to make this determination in 254 of the denial letters (or 94.8% of the total denial letters involving the commerciality doctrine), but applied the commensurate in scope test in six of the denial letters (or 2.2% of the total denial letters involving the commerciality doctrine). It appears that the commensurate in scope test is falling slowly to the wayside.[139] Earlier in the study period, the Service used the commensurate in scope test alone to determine an applicant was engaged in substantial commercial activity in several cases.[140] However,

[139] The primary purpose test finds more support in case law. For example, in *SICO Foundation v. United States*, the Court of Claims considered whether an organization that owned controlling interests in several businesses engaged in selling and distributing petroleum products and whose net income was distributed to state teachers colleges for scholarships qualified for exempt status. SICO Found. v. United States, 295 F.2d 924 (Ct. Cl. 1961). The court held that the source rather than the destination of income determines whether the organization earning the income is entitled to tax exemption, and where the primary purpose of the organization is the carrying on of a business, the organization is not exempt from tax even though all of its income is devoted to charitable purposes. *Id.* at 925–26. The court concluded that although the organization gave its profits to charitable organizations, it did not qualify for exemption under section 501(c)(3) because the organization was primarily operated to carry on the business of selling petroleum products. *Id.* at 927; *see also* Living Faith Inc. v. Comm'r, 60 T.C.M. (CCH) 710, 713 (1990) T.C.M. (RIA) ¶ 90,484 (1990), *aff'd* 950 F.2d 365 (7th Cir. 1991); Airlie Found. v. Comm'r, 283 F. Supp. 2d 58 (D.D.C. 2003).

[140] *See, e.g.*, I.R.S. Priv. Ltr. Rul. 2005-12-027 (Dec. 27, 2004) (applicant acting as facilitator of boat donations did not expend amounts for exempt purposes commensurate in scope with its financial resources when the applicant retained 50% of proceeds from the sale of the donated boats); I.R.S. Priv. Ltr. Rul. 2005-08-017 (Nov. 9, 2004) (operation of internet shopping portal which donated a portion of sales to "nonprofits" determined not to be exempt because the applicant's contribution to nonprofits was not commensurate in scope with its unrelated business income generated from the shopping portal).

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by 2015, the Service used the primary purpose test in all of the determinations that an applicant engaged in substantial commercial activity.[141]

In applying the primary purpose test, the Service often applied the factors set forth in *Airlie Foundation v. Commissioner*[142] and *Living Faith Inc. v. Commissioner*.[143] Table 4a identifies the factors the Service used to base its conclusion that an applicant engaged in substantial commercial activity in the denial letters examined. The factors cited are that the applicant charged market rates for its goods or services, the applicant did not provide a substantial amount of goods or services at or below cost, the applicant engaged in promotion of its goods and services or delivery of its goods and services in a manner similar to its for-profit competitors, and a substantial portion of the applicant's revenues resulted from the sale of the applicant's goods or services. In many of the denial letters in which substantial commercial activity was identified, the Service cited multiple reasons why a particular applicant engaged in substantial commercial activity. Accordingly, a particular denial letter in the data set may be counted more than once in

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[141] But, in one 2015 ruling, the Service also identified the commensurate in scope test as the basis for determining the applicant was engaged in substantial commercial activity. I.R.S. Priv. Ltr. Rul. 2015-40-016 (July 9, 2015). In this ruling, the applicant planned to provide public awareness on the need for spaying and neutering animals, free or reduced boarding and veterinary care for stray and rescued animals, and financial support for other like-minded organizations, all of which were recognized exempt activities described in Section 501(c)(3). However, these activities would be financed by the applicant's primary activity of providing pet boarding and veterinary services to the public for a fee. The Service's rationale for denying exemption to this applicant conflates the primary purpose and commensurate in scope tests:

> By providing awareness on the need for spaying and neutering animals you are similar to the organization in Rev. Rul. 74-194. However, unlike the organization in Rev. Rul. 74-494, this is not your primary activity and only an insubstantial portion of your activities is devoted to the prevention of cruelty to animals. You are similar to the organization in Rev. Rul. 73-127 because the operation of your pet boarding, veterinary, fitness and spa, and grooming services is an independent objective of your organization. Although a portion of your revenue may be used provide public awareness on the need for spaying and neutering animals, free or reduced boarding and veterinary care for stray and rescued animals, or financial support for other like-minded organizations, the boarding, veterinary, fitness and spa, and grooming services are conducted on a scale larger than is reasonably necessary for the performance of your educational and charitable activities.

Id. In a 2016 ruling, the Service refused to apply the commensurate in scope test to a religious organization that operated a coffee shop and donated 100% of its profits to its religious ministry. I.R.S. Priv. Ltr. Rul. 2016-45-017 (Aug. 11, 2016) ("[C]ontributing net profits to charity does not make a business exclusively charitable.").

[142] Arlie Found. v. IRS, 283 F. Supp. 2d 58 (D.D.C. 2003).

[143] Living Faith Inc. v. Comm'r, 950 F.2d 365 (7th Cir. 1991).

Table 4a because the Service cited more than one factor as the basis for its determination that the applicant engaged in substantial commercial activity.

Table 4a

Factors Considered in Applying the Primary Purpose Test

Factors Considered in Applying the Primary Purpose Test	Number of Applicants in Data Set	Percentage of Applicants in Data Set (Total Data Set = 254)
Applicant charged market rate for its goods or services	130	48.5%
Applicant sold its goods or services at or above cost (e.g., profit motive)	75	28.0%
Applicant promoted or distributed its goods or services in a manner similar to its for-profit competitors	170	63.4%
A substantial portion of the applicant's revenues resulted from the sale of goods or services; the applicant did not rely on donations or public support	117	43.7%

To illustrate the analysis the Service uses regarding the commerciality doctrine, I provide a representative example of an organization engaging in substantial commercial activity. In this example, an applicant who purchased computers from suppliers and resold the computers to students and educational providers with additional warranties and service offerings was engaged in substantial commercial activity under the primary purpose test and, therefore, was not exempt as an organization described in Section 501(c)(3):

> Your sole activity consists of securing purchase orders, securing computers from suppliers, installing software, sending the computers to the education providers, collecting fees for services, and providing a warranty for parts and maintenance. Providing these services on a regular basis for a fee is a trade or business ordinarily carried on for profit. The fact that the services are provided at a rate lower than a for-profit retailer and solely for education providers and students is not sufficient

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> to characterize this activity as charitable within the meaning of section 501(c)(3) of the Code. Although the end result may be that students have access to computers, you are operating a business to achieve that result. Therefore, you are not organized and operated exclusively for an exempt purpose.[144]

The Service then described the factors it considered in making its determination that the applicant was engaged in substantial commercial activity:

> By purchasing computers from suppliers and reselling them to students and education providers, you are in direct competition with other for-profit commercial entities that sell computers. Although your sales prices may be lower than some of your for-profit competitors, your fees are still set above your costs, you will have paid staff, and you do not solicit charitable donations. In addition, like Airlie Foundation v. Commissioner, you use commercial promotional methods such as PR campaigns and the mailing of brochures to advertise your products and services.[145]

While the Service has not articulated a bright line rule for percentages of an organization's overall activities, revenues or expenditures that would constitute substantial commercial activity, in a few rulings, the Service identified percentages of the applicant's activities, revenues or expenditures involved in the commercial activity. For example, one applicant was determined to engage in substantial commercial activity when its unrelated business income comprised 22% of its total income over the prior three years and grants and donations amounted to only 12% of the organization's income.[146] In another example, the Service noted that the applicant spent 85% of its time on nonexempt record label activities.[147] In another ruling, the

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[144] I.R.S. Priv. Ltr. Rul. 2015-45-031 (Aug. 11, 2015).

[145] *Id.*

[146] I.R.S. Priv. Ltr. Rul. 2015-29-013 (Apr. 23, 2015) (however, these percentages do not take into account the applicant's revenues from the operation of a golf course, which the Service determined to be a commercial activity in addition to the snack bar and restaurant operations reported by the organization as unrelated business income).

[147] I.R.S. Priv. Ltr. Rul. 2015-45-030 (June 22, 2015). The Service described the organization's nonexempt record label activities as follows:

> You are unlike the organization described in Rev. Rul. 67-392 which promoted the advancement of young musical artists by conducting weekly workshops, sponsoring public concerts by the artists, and securing paid engagements. You are looking for promising artists to create records and then sell them in a commercial manner. Any educational or charitable activities you conduct are incidental to your commercial purpose of operating a record label.

Service determined an organization was engaged in substantial commercial activity when 45% of its activities were commercial technical services and consulting and 55% of its activities were the provision of educational seminars.[148] In most cases, however, it could not be determined how much time, revenue or expenditures were dedicated to the nonexempt commercial activities of the organization due to the redacted nature of the denial letters.

3. Private Benefit

Table 4b identifies the factors the Service used to reach its conclusion that an applicant engaged in substantial private benefit. The factors cited are that the applicant did not benefit a charitable class, the applicant benefitted the organization's members rather than the general public, and the applicant benefitted a for-profit company not related to the organization. Additionally, the Service cited control of the organization by a group of related individuals and benefits flowing to an organization controlled by an officer or director of the organization as additional factors resulting in substantial private benefit. However, these two factors better evidence potential prohibited private inurement, which is distinct from the private benefit doctrine. Accordingly, I have classified these applicants as being denied based on the private inurement doctrine rather than the private benefit doctrine. In many of the denial letters, the Service identifies potential private inurement as substantial private benefit. Thus, it is difficult to assess the extent of the application of the private benefit doctrine versus the extent of the application of the private inurement doctrine in the data set as the Service often conflates the two doctrines. In many of the denial letters in which substantial private benefit was identified, the Service cited multiple reasons why a particular applicant engaged in substantial private benefit. Accordingly, a particular denial letter in the data set may be counted more than once in Table 4b because the Service cited more than one factor as the basis for its determination that the applicant engaged in substantial private benefit.

Id.

[148] I.R.S. Priv. Ltr. Rul. 2014-03-017 (Oct. 24, 2013) ("Your educational activity is incidental to your primary activity which is to provide website and other related technical services to your clients for a fee.").

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Table 4b

Basis for Violation of the Limitation on Private Benefit

Basis for Violation of the Limitation on Private Benefit	Number of Applicants in Data Set	Percentage of Applicants in Data Set (Total Data Set = 283)[149]
Organization's activities did not benefit a charitable class	79	27.9%
Organization operated primarily for the benefits of its members	70	24.7%
Organization directed business to one or more for-profit entities unrelated to the organization	102	36.0%

Of the organizations determined to engage in substantial private benefit, approximately 28% engaged in activities that did not benefit a charitable class. Many of these organizations provided financial assistance for education or health needs of a single individual or descendants of a specified family which did not constitute an indefinite charitable class.[150] Approximately 25% of the organizations operated primarily to benefit the private interests of its members who did not constitute a charitable class. The Service also determined that directing business to for-profit entities through the conduct of the organization's exempt activities resulted in substantial private benefit in approximately 36% of the cases.[151]

[149] In some cases, the Service stated that the applicant did not provide sufficient information for the Service to determine that the applicant did not operate in a manner that provided more than insubstantial private benefit and did not provide additional rationale.

[150] *See, e.g.*, I.R.S. Priv. Ltr. Rul. 2015-02-017 (Oct. 14, 2015); I.R.S. Priv. Ltr. Rul. 2004-47-050 (Nov. 19, 2004); I.R.S. Priv. Ltr. Rul. 2015-05-039 (Oct. 22, 2014); I.R.S. Priv. Ltr. Rul. 201-51-1026 (Dec. 19, 2014).

[151] *See, e.g.*, I.R.S. Priv. Ltr. Rul. 2015-07-023 (Nov. 21, 2014) (operation of a booster club for amateur sports competition resulted in private benefit to the owner of the gym where the amateur athletes trained and which sponsored all of the teams on which the athletes competed); I.R.S. Priv. Ltr. Rul. 2005-08-017 (Nov. 9, 2004) (operation of an internet shopping portal which donated a portion of its sales to

In one representative example, the Service denied exemption to an open source software provider, noting the distinction between "public good" and charitable class:

> Whatever public good the Tools provide, it is not the type of benefit to the community contemplated by section 501(c)(3). Not all organizations which incidentally enhance the public good will be classified as "public" organizations within the meaning of section 501(c)(3). For example, . . . commerce clearly provides an economic benefit to the community, but section 1.501(c)(3)-1(c)(1) and section[sic] 511-514 limit the kinds and amounts of commerce exempt organizations may conduct. It is significant that Congress enacted special exemption provisions for certain types of organizations which would be unable to meet the stricter section 501(c)(3) tests which require service to public interests rather than to private ones. Accordingly, because you do not limit use of the Tools to a charitable class, the development and distribution of the Tools to the public under open source licenses is not the type of benefit to the community contemplated by section 501(c)(3) and does not further a charitable purpose.[152]

4. Public Policy Limitation was not Evident to a Substantial Degree

On the whole, the public policy limitation was not evident in a significant number of the denial letters examined in the study. Thirteen of applicants in the data set of 588 denial letters (or 2.4%) were denied charitable status on the basis of the applicant violating the public policy limitation. Table 4c sets for the basis on which the Service determined that these thirteen applicants violated the public policy limitation.

"nonprofits" resulted in private benefit to the for-profit shopping partners through advertising and web traffic); I.R.S. Priv. Ltr. Rul. 2004-50-039 (Sept. 14, 2004) (credit counseling organization provided private benefit to unrelated credit card companies by acting as debt collector for the credit card companies in exchange for a lead fee); I.R.S. Priv. Ltr. Rul. 2005-38-028 (June 30, 2005) (credit counseling organization provided private benefit to unrelated credit card companies by acting as debt collector for the credit card companies in exchange for a lead fee); I.R.S. Priv. Ltr. Rul. 2005-36-022 (May 26, 2005) (credit counseling organization provided private benefit to unrelated credit card companies by acting as debt collector for the credit card companies in exchange for a lead fee); I.R.S. Priv. Ltr. Rul. 2005-28-028 (Oct. 19, 2004) (credit counseling organization provided private benefit to unrelated credit card companies by acting as debt collector for the credit card companies in exchange for a lead fee); I.R.S. Priv. Ltr. Rul. 2005-10-044 (Mar. 11, 2005) (credit counseling organization provided private benefit to unrelated credit card companies by acting as debt collector for the credit card companies in exchange for a lead fee).

[152] I.R.S. Priv. Ltr. Rul. 2015-05-040 (Nov. 6, 2014).

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Table 4c

Basis for Violation of the Public Policy Doctrine

Basis for Violation of the Public Policy Doctrine	Number of Applicants in Data Set	Percentage of Applicants in Data Set (Total Data Set = 13)
Organization operated in a way that promoted illegal activity	7	53.8%
Organization operated a racially discriminatory school	5	38.5%
Organization's operations otherwise violated established public policy	1	7.7%

Many of these organizations operated schools with racially discriminatory policies,[153] and thus operated in violation of the public policy limitation espoused by the Supreme Court in *Bob Jones University v. United States*.[154] In an unusual case, the Service denied exemption on public policy grounds to an organization operated to promote decriminalization of pedophile laws which was founded by a convicted sex offender.[155] The Service reasoned:

> The application Form 1023 articulates the organization's primary activity and purpose is to decriminalize or change laws that prohibit the sexual exploitation of a minor. In addition, the policy "working for law change concerning the rights of sexual active consenting kids and adults" is stated in the purpose clause of the

[153] I.R.S. Priv. Ltr. Rul. 2004-47-038 (Aug. 24, 2004); I.R.S. Priv. Ltr. Rul. 2005-27-021 (Apr. 12, 2005); I.R.S. Priv. Ltr. Rul. 2013-25-015 (Mar. 28, 2013); I.R.S. Priv. Ltr. Rul. 2010-41-046 (July 20, 2010); I.R.S. Priv. Ltr. Rul. 2010-36-024 (June 14, 2010); I.R.S. Priv. Ltr. Rul. 2010-33-039 (May 28, 2010); I.R.S. Priv. Ltr. Rul. 2009-09-064 (Dec. 3, 2008); I.R.S. Priv. Ltr. Rul. 2007-03-039 (Oct. 26, 2006).

[154] Bob Jones Univ. v. United States, 461 U.S. 574 (1982).

[155] I.R.S. Priv. Ltr. Rul. 2008-26-043 (June 27, 2008).

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> organizing documents. Therefore, the purpose for which the organization is formed is contrary to public policy to protect the sexual exploitation of children.[156]

The Service's denial of exemption was upheld by the Tax Court, although the Tax Court also noted the organization proposed to promote illegal activities by encouraging sexual activity with minors with the goal of repealing child pornography and rape laws.[157]

In addition, the Service denied exemption to seven organizations on the basis that the organization's activities promoted illegal activities. Three of these organizations promoted polygamy which was illegal under applicable state law.[158] Three organizations were formed to distribute medical marijuana in jurisdictions where applicable state law permitted marijuana to be consumed for medical use.[159] However, the Service relied on federal law treating marijuana as a controlled substance and determined that the organization's distribution of marijuana in violation of federal law promoted illegal activity.[160] Finally, for one organization, the Service denied exemption on the basis that the organization's activities may be illegal in other countries in which the organization would operate.[161] The organization described itself as an information security company with the goal of assisting non-governmental organizations abroad establish or reestablish websites and

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[156] *Id.* The organization's purpose clause stated: "Working for law change to protect the rights of sexual active consenting kids and adults, and to amend child sexual photography law; to provide counseling to sexual active kids and adults; and scientific studies; educational & artistic." *Id.*

[157] Mysteryboy, Inc. v. Comm'r, 99 T.C.M. (CCH) 1057, 2010 (RIA) T.C.M. 2010-013 (2010).

[158] I.R.S. Priv. Ltr. Rul. 2013-23-025 (June 7, 2013); I.R.S. Priv. Ltr. Rul. 2013-25-015 (Mar. 28, 2013); I.R.S. Priv. Ltr. Rul. 2013-10-047 (Mar. 8, 2013).

[159] I.R.S. Priv. Ltr. Rul. 2016-15-018 (Apr. 8, 2016); I.R.S. Priv. Ltr. Rul. 2013-33-014 (Aug. 16, 2013); I.R.S. Priv. Ltr. Rul. 2012-24-036 (June 15, 2012).

[160] For example, in one ruling, the Service reasoned:

> Your primary activity, the distribution of cannabis, is illegal. Federal law does not recognize any health benefits of cannabis and classifies it as a controlled substance. . . . Current federal law prohibits the use of cannabis except in limited circumstances; those limited circumstances do not include the use of cannabis for medicinal purposes. The fact that B legalized distribution of cannabis to a limited extent is not determinative because under federal law, distribution of cannabis is illegal. Because you advocate and engage in activities that contravene federal law, you serve a substantial nonexempt purpose. I.R.S. Priv. Ltr. Rul. 2016-15-018 (Apr. 8, 2016).

[161] I.R.S. Priv. Ltr. Rul. 2014-05-022 (Jan. 31, 2014).

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block outsiders attempting to obstruct them.[162] In rejecting the organization's application, the Service stated:

> [Y]ou help individuals and organizations in foreign countries maintain access to the internet, which you state is a fundamental human right under the United Nations Universal Declaration of Human Rights. However, the United Nations Universal Declaration of Human Rights is a declaration, not a treaty or a law, and therefore does not elevate internet access to the level of a human and civil right secured by law. On the other hand, you also state that your activities promote free speech. Freedom of speech is one of the fundamental freedoms guaranteed by the United States Constitution. Nonetheless, the United States Constitution applies only to U.S. residents and citizens, not residents or citizens of foreign countries. Finally, you provide no information indicating that your activities in foreign countries are legal under those countries' laws. Accordingly, your activities do not defend human and civil rights secured by law.[163]

C. Basis for Violation of the Private Inurement Prohibition

Table 5 identifies the factors the Service used to base its conclusion that an applicant engaged in private inurement. The factors cited are that the applicant paid its officers or directors excessive compensation, the applicant engaged in a loan, lease, royalty or other transaction with an officer and director on terms that provided more than fair market benefit to the officer or director, and the applicant operated in a way that directed business or other benefits to a for-profit company controlled by an insider. In addition, the Service identified potential private inurement transactions between the organization and its insiders, such as compensation or loans or leases, but stated that the applicant did not provide sufficient information for the Service to determine whether the proposed transactions were reasonable and did not provide more than fair market value benefit to the insider. As a result, the Service concluded that the applicant violated the private inurement prohibition as the burden is on the applicant to prove that the applicant satisfies the five-part test for exemption and the applicant did not meet its burden. Finally, there are instances in which no proposed transaction between the applicant and its insiders is identified in the denial letter, yet the Service determined that the applicant could not establish that private inurement

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[162] *Id.*

[163] *Id.* (internal citations omitted).

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would not occur due to the applicant's governance structure.[164] In many of the denial letters in which prohibited private inurement was identified, the Service cited multiple reasons why a particular applicant engaged in prohibited private inurement. Accordingly, a particular denial letter in the data set may be counted more than once in Table 5 because the Service cited more than one factor as the basis for its determination that the applicant engaged in prohibited private inurement.

Table 5

Basis for Violation of the Prohibition on Private Inurement

Basis for Violation of the Prohibition on Private Inurement	Number of Applicants in Data Set	Percentage of Applicants in Data Set (Total Data Set = 290)
Organization paid or proposed to pay excessive compensation to its insiders or organization paid or proposed to pay compensation to its insiders and failed to provide sufficient documentation to establish that the compensation was reasonable	37	12.8%
Organization engaged in or proposed to engaged in a loan, lease, royalty or other transaction with insiders without the organization receiving a return benefit of equivalent value or failed to provide sufficient documentation	66	22.8%

[164] The Service often relied on *Bubbling Well Church of Universal Love, Inc. v. Commissioner* in which the Tax Court denied exemption to a small family church. While the Tax Court recognized that the presence of a small, closely-related governing board alone was not a sufficient basis on which to deny tax exemption, the court found that the close family relationship of the organization's three-member governing board put those individuals in a position to "without challenge, . . . dictate [the church's] program[s] and operations, prepare its budget, and spend its funds, and [that they] could continue to do so indefinitely." Bubbling Well Church of Universal Love, Inc. v. Comm'r, 74 T.C. 531, 534–35 (1980), *aff'd*, 670 F.2d 104 (9th Cir. 1981). When combined with the applicant's vague and uninformative responses to the Service's questions about expenditures and activities, denial of exemption was upheld, because the applicant failed to meet its burden of showing the absence of private inurement to its insiders.

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Basis for Violation of the Prohibition on Private Inurement	Number of Applicants in Data Set	Percentage of Applicants in Data Set (Total Data Set = 290)
to establish that the organization received a return benefit of equivalent value		
Close relationship between organization's activities and operations of a for-profit business controlled by an insider provided opportunity for directing additional sales, clients or other benefits to the for-profit business or opportunity for provision of services by the charitable organization to inure to the benefit of its insiders	112	38.6%
Organization's governance structure presented opportunity for future private inurement, but no specific proposed transaction was identified	97	33.4%

Typical cases of private inurement include transfer or use of the organization's income or assets by the organization's insiders without the organization receiving a return benefit of equivalent value. In some cases, the applicant did not provide documentation that the payments made to the organization's insiders represent fair market value compensation for the insider's services or use of property owned by the insider.[165] Additionally, compensation of the organization's officers and directors was highly scrutinized. In one example, the Service determined that payment of a percentage of the organization's gross revenues as compensation for an officer's services was private inurement.[166]

[165] *See, e.g.*, I.R.S. Priv. Ltr. Rul. 2004-47-049 (Nov. 19, 2004) (no evidence to support value of payments of rents to and purchase of property from organization board members).

[166] I.R.S. Priv. Ltr. Rul. 2004-50-043 (Dec. 10, 2004).

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However, consideration of private inurement was not limited to exchanges of economic benefit between the organization and its insiders. For example, the Service determined that shared office space between the organization and the for-profit business of its board members presented a "great likelihood of inurement" in that the proximity of the two offices could steer clientele of the applicant to the for-profit business operated by its board members.[167] In another example, the Service determined that an applicant providing open source software provided prohibited private inurement to its directors by promoting the development and distribution of software codes owned by the directors.[168] Conflating the private inurement doctrine and private benefit doctrine, the Service explains:

> No amount of private inurement is permitted. The [private] benefit does not have to be economic. [T]he tax court defined private benefit to include any "advantage; profit; fruit; privilege; gain or interest." At least four of your board members own code incorporated into Player. Private persons generally own property for personal purposes which are not per se exempt purposes. Moreover, your Website links to the association of programmers' website that has a Consulting Tab where some of your board members offer their consulting services to the public for a fee as "the world's leading experts in the [Software]." Your activities of 'promoting' the Player are marketing activities that provide an "advantage; profit; fruit; privilege; gain or interest" to those board members who own Player code. Because you provide private inurement within the meaning of section 501(c)(3) you are not operated exclusively to further section 501(c)(3) exempt purposes.[169]

Among the denial letters examined in which the Service determined the applicant engaged in prohibited private inurement, the Service commented on the governance structure of the applicant in 235 (or 81.0%) of these cases. While the Code and Treasury Regulations do not specify any governance standards that must be satisfied in connection with complying with the prohibition on private inurement, it is clear from the denial letters examined that the Service strongly considers "best practices" in corporate governance as key to avoiding potential private inurement. In particular, the Service discourages less than three members of a governing board[170] and encourages

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[167] I.R.S. Priv. Ltr. Rul. 2005-14-021 (Jan. 13, 2005).

[168] I.R.S. Priv. Ltr. Rul. 2015-05-041 (Nov. 6, 2014).

[169] *Id.*

[170] *See, e.g.*, I.R.S. Priv. Ltr. Rul. 2004-50-037 (Sept. 17, 2014) (one director); I.R.S. Priv. Ltr. Rul. 2004-50-039 (Sept. 14, 2004) (two directors). The Service justified its examination of the number of persons serving on the governing board by equating the situation to lack of public support for the

a majority of the members of the governing board to be independent.[171] The Service also discourages compensation of the applicant's board members and views the adoption of a conflict of interest policy as key, even though not required under applicable federal law.[172] Table 5a identifies the governance factors the Service considered among the applicants in the denial letters examined who were determined to engage in prohibited private inurement. In many of the denial letters in which governance factors was identified, the Service cited multiple factors why the applicant's governance structure resulted in or posed a risk of private inurement. Accordingly, a particular denial letter in the data set may be counted more than once in Table 5a because the Service cited more than one factor.

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organization: "[A]nother form of public support is through the participation of knowledgeable or representative and independent persons on the board as volunteers." I.R.S. Priv. Ltr. Rul. 2004-50-037 (Sept. 17, 2014). Lack of such support would indicate the organization is operated for private benefit. *Id.*

[171] *See, e.g.*, I.R.S. Priv. Ltr. Rul. 2015-26-020 (Apr. 2, 2015) (Service required organization to add four board members to the organization's existing three person related board); I.R.S. Priv. Ltr. Rul. 2015-15-037 (Jan. 13, 2015) (three of five board members related); I.R.S. Priv. Ltr. Rul. 2005-35-029 (June 9, 2005) (organization expanded its board at the request of the Service so that a majority of board members would be independent); I.R.S. Priv. Ltr. Rul. 2004-47-049 (Nov. 19, 2004) (three of five board members related); I.R.S. Priv. Ltr. Rul. 2005-06-038 (Feb. 11, 2005) (board of three related individuals present "serious risk of inurement").

[172] *See* ADVISORY COMMITTEE ON TAX EXEMPT AND GOVERNMENT ENTITIES (ACT), THE APPROPRIATE ROLE OF THE INTERNAL REVENUE SERVICE WITH RESPECT TO TAX-EXEMPT ORGANIZATION GOOD GOVERNANCE ISSUES 3, at 33, 35 (June 11, 2008), http://www.irs.gov/pub/irs-tege/tege_act_rpt7.pdf, which reports:

> Our personal experience and research for this report suggest, however, that the IRS may require specific governance practices on an ad hoc and inconsistent basis. For example, determination specialists may require organizations seeking exemption to have independent boards or at least some independent board members. Similarly, despite the fact that the Form 1023 specifically states that a conflict of interest policy is recommended but not required, our experience and interviews suggest that determination specialists often require adoption of such a policy, and occasionally require adoption of the sample form of policy included with the Form 1023 instructions. . . . We are concerned about the IRS having this level of discretion in cajoling or requiring specific governance process, particularly in the determination phase, where there usually is no track record evidencing operational failures.

In a recent denial letter, the Service cited the organization's lack of conflict of interest policy as a factor in its determination that the organization did not qualify for exempt status: "You do not have a community-based board and do not have conflict of interest policy in place to safeguard charitable assets from being diverted for any private purposes." I.R.S. Priv. Ltr. Rul. 2015-25-014 (Mar. 24, 2015).

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Table 5a

"Best Practices" in Governance Considered by the Service

"Best Practices" in Governance Considered by the Service	Number of Applicants in Data Set	Percentage of Applicants in Data Set
The number of directors of the organization was too few	177	75.3%
A majority of the directors of the organization should be independent	208	88.5%
A majority of the directors should not receive compensation for their services	44	18.7%
The organization should have a conflict of interest policy	22	9.4%
The director's qualifications should include experience related to the organization's proposed activities	11	4.7%

Table 6b identifies the relationship between the governance "best practices" identified by the Service and the determination that the applicants in the data set failed to satisfy the private inurement prohibition. First, I distinguish applicants that engaged or proposed to engage in transactions with its insiders from applicants which did not identify proposed transactions with its insiders in their applications for exemption. Second, I identify cases in which the Service requested that the applicant change its governance structure to comport with one or more of the best practices identified during the application process and note whether the applicant complied with the request. Finally, I identify the number of denial letters in which a governance "best practice" is identified as separate criteria explaining the Service rationale for denial of exemption. While there are no instances in which an applicant's failure to comply with governance best practices alone serves as the basis for denial, it is interesting to identify the cases in which the Service cites governance best practices as one of the reasons why exemption is denied because there is no statutory or regulatory law or published Service guidance on which taxpayers may rely establishing governance structure of charitable organizations generally as a basis for denying exemption.

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Table 6b

"Best Practices" in Governance and Relation to Private Inurement

"Best Practices" and Relation to Private Inurement	Number of Applicants in Sample Failing to Meet Test	Percentage of Applicants in Sample Failing to Meet Test (Total Data Set = 235)
Organization did not comport with one or more "best practices" and engaged or proposed to engage in private inurement	138	58.7%
Organization did not comport with one or more "best practices" and did not engage or proposed to engage in private inurement	97	41.2%
Organization requested to change governance structure or practices and complied with request	9	3.8%
Organization requested to change governance structure or practices and did not comply with request	2	0.9%
Governance "best practice" listed as separate identified criteria why the applicant was denied exemption	49	20.9%

Importantly, the Service used an applicant's failure to comport with "best practice" as grounds for improper private inurement in cases in which the applicant proposed no transactions between the applicant and its insiders.[173] These cases comprised a substantial number of the total

[173] *See, e.g.*, I.R.S. Priv. Ltr. Rul. 2005-35-029 (June 9, 2005); I.R.S. Priv. Ltr. Rul. 2005-06-038 (Feb. 11, 2005).

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applications denied on the basis of engaging in prohibited private inurement. Without protective governance mechanisms in place, the Service expressed concern that these applicants could engage in transactions with its insiders in the future and the applicant had no internal checks to ensure that these transactions were reasonable and fair to the applicant and would not result in private inurement.[174]

D. Public Charities Denied Exemption More Than Private Foundations

In general, a charitable organization is presumed to be a private foundation unless it can establish that it qualifies as a public charity under Sections 509(a)(1)-(3). Types of public charities described under Section 509(a)(1) include churches, schools, hospitals, government entities and university endowment funds.[175] In addition, an organization that normally receives more than one-third of its total support from contributions from the general public is considered a public charity under Section 509(a)(1).[176] An organization that receives more than one-third of its total support from exempt function revenues, such as admission fees to a museum or patient revenues for a hospital, is considered a public charity under Section 509(a)(2), provided the organization does not normally receive more than one-third of its support from gross investment income. An organization that does not meet either of these tests may still qualify as a public charity under Section 509(a)(3) as a "supporting organization" of another public charity by virtue of the relationship between the first organization and the second public charity.[177]

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[174] *See, e.g.*, I.R.S. Priv. Ltr. Rul. 2015-25-014 (Mar. 24, 2015) ("You do not have a community-based board and do not have conflict of interest policy in place to safeguard charitable assets from being diverted for any private purposes."); I.R.S. Priv. Ltr. Rul. 2005-06-038 (Feb. 11, 2005) (board of related individuals presents a "serious risk" of private inurement); I.R.S. Priv. Ltr. Rul. 2004-47-049 (Nov. 19, 2004) ("Undue control of the organization by a related board causes the organization to serve private interests and thus fail the operational test.").

[175] I.R.C. § 509(a)(1) ("an organization described in section 170(b)(1)(A) other than in clauses (vii) and (viii)").

[176] I.R.C. §§ 509(a)(1), 170(b)(1)(A)(vi); Treas. Reg. § 1.170A-9(e) (as amended in 2011).

[177] Organizations that support a public charity are allowed public charity status if they meet certain requirements. These "supporting organizations" are grouped into three types: (i) those that are "operated, supervised, or controlled by" the public charity they support (Type I); (ii) those that are "supervised or controlled in connection with" the public charity they support (Type II); and (iii) those that are "operated

Private foundations generally are subject to more stringent restrictions on their activities.[178] For example, public charities are permitted to engage in transactions with their officers and directors, provided the terms of such transactions are reasonable and fair to the charity and do not result in private

in connection with" the public charity they support (Type III). I.R.C. § 509(a)(3). Type III supporting organizations are further divided into functionally integrated Type III supporting organizations and other Type III supporting organizations. A functionally integrated Type III supporting organization is defined as a Type III supporting organization that is not required to make payments to the supported organizations due to the supporting organization's activities being related to performing the functions of, or carrying out the purposes of, such supported organizations. I.R.C. § 4943(f)(5)(B). Treasury Regulations provide an integral part test to determine whether a Type III supporting organization qualifies as a functionally integrated Type III supporting organization. *See* Treas. Reg. § 1.509(a)-4(i)(4). A Type III supporting organization satisfies this integral part test if it either (1) serves as the parent of each of its supported organizations or (2) engages in activities (i) substantially all of which directly further the exempt purposes of its supported organizations, by performing the functions of, or carrying out the purposes of, such supported organizations, and (ii) that, but for the involvement of the supporting organization, would normally be engaged in by its supported organizations. *Id.* As the Joint Committee on Taxation explains:

> The current such regulation is Treasury regulation section 1.509(a)-4(i)(3)(ii). Under Treasury regulation section 1.509(a)-4(i)(3), the integral part test of current law may be satisfied in one of two ways, one of which requires a payout of substantially all of an organization's income to or for the use of one or more publicly supported organizations, and one of which does not require such a payout. There is concern that the current income-based payout does not result in a significant amount being paid to charity if assets held by a supporting organization produce little to no income, especially in relation to the value of the assets held by the organization, and as compared to amounts paid out by nonoperating private foundations. There also is concern that the current regulatory standards for satisfying the integral part test not by reason of a payout are not sufficiently stringent to ensure that there is a sufficient nexus between the supporting and supported organizations. In revising the regulations, the Secretary has the discretion to determine whether it is appropriate to impose a payout requirement on any or all organizations not currently required to pay out. It is intended that, in revisiting the current regulations, if the distinction between Type III supporting organizations that are required to pay out and those that are not required to pay out is retained, which may be appropriate, the Secretary nonetheless shall strengthen the standard for qualification as an organization that is not required to pay out. For example, as one requirement, the Secretary may consider whether substantially all of the activities of such an organization should be activities in direct furtherance of the functions or purposes of supported organizations.

Staff of the Joint Comm. on Tax'n, 109th Cong., Technical Explanation of H.R. 4, The "Pension Protection Act of 2006," JCX-38-06 (Aug. 3, 2006), at 360 n.571.

[178] *See* I.R.C. §§ 4941 (prohibition on self-dealing), 4942 (requirement generally to distribute at least five percent of the fair market value of the organization's assets each year), 4943 (prohibition on excess business holdings), 4944 (prohibition on jeopardizing investments), and 4945 (prohibition on taxable expenditures, including lobbying).

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inurement.[179] Private foundations, on the other hand, are strictly prohibited from engaging in transactions with their officers and directors, subject to certain enumerated exceptions, even if such transaction is beneficial to the private foundation.[180] As another example, private foundations generally are prohibited from engaging in any lobbying activity[181] while public charities may engage in insubstantial lobbying activity.[182]

Table 6 sets forth the type of status sought by the applicants in the data set in the applicants' applications for exemption.

Table 6

Public Charity/Private Foundation Status Sought by Applicant

Public Charity/Private Foundation Status Sought by Applicant	Number of Applicants in Data Set	Percentage of Applicants in Data Set (Total Data Set = 603)
Public charity described in Section 509(a)(1) or 509(a)(2)	554	91.9%
Public charity described as a supporting organization in Section 509(a)(3)	21	3.5%
Private non-operating foundation	19	3.1%
Private operating foundation	2	0.3%
Not identified	7	1.2%

[179] *See* I.R.C. §§ 501(c)(3), 4958 (describing "excess benefit transactions" between public charities and their insiders).

[180] *See* I.R.C. § 4941 (prohibiting self-dealing transactions between private foundations and their insiders, with limited exceptions).

[181] *See* I.R.C. § 4945(d) (defining a taxable expenditure subject to excise tax as funds expended for lobbying activities). Private foundations may engage in lobbying to the extent such lobbying activity is related to "an appearance before, or communication to, any legislative body with respect to a possible decision of such body which might affect the existence of the private foundation, its powers and duties, its tax-exempt status, or the deduction of contributions to such foundation." I.R.C. § 4945(e).

[182] *See* I.R.C. § 501(c)(3), (h)(4).

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Substantially all of the applicants in the data set denied exemption sought classification as a public charity while a limited number of the applicants denied exemption purported to be private foundations. Of the applicants attempting to qualify as a public charity, very few claimed status as a supporting organization. Substantially all of these applicants claimed qualification as a public charity under either section 509(a)(1) or 509(a)(2).

E. Streamlined Exemption Application for Smaller Charitable Organizations is not Rigorous Enough

In 2014, the Service introduced a streamlined exemption application (Form 1023-EZ) that could be used by certain applicants that had assets of $250,000 or less and expected its annual gross revenues for the next three years not to exceed $50,000.[183] Even if a charity satisfies these financial tests for 1023-EZ eligibility, the Service has provided a list of twenty-nine additional circumstances that disqualify an organization from 1023-EZ eligibility.[184] For example, churches, schools, hospitals, cooperative hospital service organizations, health maintenance organizations, accountable care organizations, cooperative service organizations of operating educational organizations, agricultural research organizations, and qualified charitable risk pools are not permitted to use Form 1023-EZ.[185] In addition, organizations that were scrutinized in connection with the enactment of the Pension Protection Act of 2006, such as supporting organizations, credit counseling organizations, and organizations maintaining donor advised funds, may not use Form 1023-EZ.[186] The Service also prohibits private operating foundations, successor organizations to for-profit organizations, organizations currently exempt or previously recognized as exempt under Section 501(a), limited liability companies and partnerships from using Form 1023-EZ.[187] In addition, foreign organizations, organizations with foreign

[183] I.R.S. FORM 1023-EZ UPDATE REPORT, *supra* note 16, at 1; I.R.S. Instructions for Form 1023-EZ (Rev. Jan. 2017), https://www.irs.gov/pub/irs-pdf/i1023ez.pdf.

[184] I.R.S. Instructions for Form 1023-EZ, Eligibility Worksheet.

[185] *Id.*

[186] *See id.*

[187] *See id.*

mailing addresses and organizations that are successors or related to a terrorist organization whose tax-exemption has been suspended may not use Form 1023-EZ.[188] Despite the explicit instructions identifying the eligibility criteria for using Form 1023-EZ, ineligible organizations file the form nonetheless and many of these ineligible organizations receive tax exemption.[189]

Over 105,000 applicants have been approved for tax exemption using Form 1023-EZ from July 1, 2014 through December 31, 2016.[190] In fiscal year 2015 and fiscal year 2016, more applicants used Form 1023-EZ than the normal application for exemption (Form 1023).[191] Additionally, the Service identified 22% of applicants using Form 1023 that were eligible to use Form 1023-EZ from July 1, 2014 through June 24, 2016 and is investigating ways to encourage more applicants to used Form 1023-EZ.[192]

In comparison to the Form 1023, the Form 1023-EZ is much shorter and easier to complete.[193] The Form 1023-EZ requests basic information about

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[188] *Id.*

[189] NAT'L TAXPAYER ADVOCATE, *MSP #19*, *supra* note 5, at 257. The IRS's Reliance on Form 1023-EZ Causes It to Erroneously Grant Internal Revenue Code § 501(c)(3) Status to Unqualified Organizations), https://taxpayeradvocate .irs.gov/Media/Default/Documents/2016-ARC/ARC16_ Volume1.pdf ("[I]n the representative sample of 323 organizations [in the TAS study], the articles of incorporation of 12, or four percent, showed that two were limited liability companies, two were churches, seven were schools, colleges or universities or supporting organizations, and one was a private operating foundation. These organizations are never eligible to file Form 1023-EZ, yet they possess a determination letter from the IRS and are holding themselves out as tax exempt."); Terri Lynn Helge, *Hundreds of Churches Appear to Receive Exemption Determinations Using Form 1023-EZ*, NONPROFIT LAW PROF BLOG (Feb. 22, 2017), http://lawprofessors .typepad.com/nonprofit/2017/02/hundreds-of-churches-appear-to-receive-exemption-determinations-using-form-1023-ez.html (identifying 623 organizations approved for tax exemption using Form 1023-EZ with "church" in the organization's name, most of which appeared to be operating as churches, despite all of these organizations certifying that they were eligible to use Form 1023-EZ).

[190] *See* IRS News Release 2017-41 (Feb. 22, 2017), https://www.irs.gov/uac/newsroom/irs-makes-approved-form-1023ez-data-available-online.

[191] *See* I.R.S. FORM 1023-EZ UPDATE REPORT, *supra* note 16, at 2 tbl.1 (reporting that 54.9% of applicants used Form 1023-EZ in fiscal year 2015 and 57.5% of applicants used Form 1023-EZ in fiscal year 2016 through June 24, 2016).

[192] *See id.* at 1.

[193] The Form 1023-EZ is three pages, filed electronically, compared to the 12 page Form 1023, exclusive of required accompanying schedules which depend on the applicant's responses to the information requested in the 12-page form. In addition, the Paperwork Reduction Act Notice contained in the instructions for Form 1023 reports the estimated total time for recordkeeping, learning about the law,

the organization, such as the organization's name, address, employer identification number and phone number, and the names and addresses of the organization's officers and directors.[194] Then, the Form 1023-EZ contains a series of less than 15 statements and questions by which the applicant affirms that the applicant complies with the requirements for tax exemption as a charitable organization described in Section 501(c)(3).[195] For example, Part III, Line 3 of Form 1023-EZ states:

> To qualify for exemption as a section 501(c)(3) organization, you must:
>
> - Refrain from supporting or opposing candidates in political campaigns in any way.
> - Ensure that your net earnings do not inure in whole or in part to the benefit of private shareholders or individuals (that is, board members, officers, key management employees, or other insiders).
> - Not further non-exempt purposes (such as purposes that benefit private interests) more than insubstantially.
> - Not be organized or operated for the primary purpose of conducting a trade or business that is not related to your exempt purpose(s).
> - Not devote more than an insubstantial part of your activities attempting to influence legislation or, if you made a section 501(h) election, not normally make expenditures in excess of expenditure limitations outlined in section 501(h).

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and completion and submission of the 12-page Form 1023, excluding required schedules, is 105 hours and 3 minutes, while the same notice in the instructions to Form 1023-EZ reports the estimated time to recordkeeping, learning about the law, and completion and submission of the streamlined Form 1023-EZ is 18 hours and 50 minutes. The filing fee for the Form 1023-EZ is $275 fee which was reduced from an initial $400 filing fee effective July 1, 2015. *See* I.R.S. Instructions for Form 1023-EZ (Rev. Jan. 2017), https://www.irs.gov/pub/irs-pdf/i1023ez.pdf. In contrast, the filing fee for the Form 1023 is $850, although a reduced filing fee of $400 is available for organizations which have gross receipts that do not exceed $10,000 annually for a four-year period. *See* I.R.S. Form 1023, Application for Recognition of Exemption Under Section 501(c)(3) (Rev. Oct. 2013), https:// www.irs.gov/pub/irs-pdf/f1023.pdf. Processing time by the Service for the Form 1023-EZ is also significantly less than the processing time for Form 1023, with the processing time for the 1023-EZ averaging 14 days as compared to processing time for the Form 1023 averaging 97 days during the time period from July 1, 2014 through June 24, 2016. Form I.R.S. 1023-EZ UPDATE REPORT, *supra* note 16, at 1.

[194] *See* I.R.S. Form 1023-EZ, Streamlined Application for Recognition of Exemption Under Section 501(c)(3) (Rev. June 2014), Part I.

[195] *Id.* at Part II and Part III.

- Not provide commercial-type insurance as a substantial part of your activities.

Check this box to attest that you have not conducted and will not conduct activities that violate these prohibitions and restrictions.[196]

Importantly, the Service does not require the applicant to submit any evidence that the claims made by the applicant on the Form 1023-EZ are true.[197] For example, both the Form 1023 and the Form 1023-EZ require the applicant to certify that the applicant's governing documents limit the applicant's purposes to only those enumerated exempt purposes in Section 501(c)(3), do not expressly empower the applicant to engage in activities that do not further the applicant's exempt purposes to more than an insubstantial degree, and provide for the applicant's assets to be used only for exempt purposes upon dissolution of the organization.[198] However, an applicant is required to submit its governing documents with the Form 1023 so that the Service can confirm the applicant's certification is true, but an applicant using Form 1023-EZ does not submit its governing documents, thereby requiring the Service to rely on the applicant's certification at face value.[199]

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[196] *Id.* at Part III, Line 3.

[197] The Service conducts a pre-determination compliance check on 3% of the Form 1023-EZ applications, selected at random, in which the Service may request from the applicant a copy of its organizing document evidencing language required to meet the organizational test, a detailed description of the applicant's past, present, and future activities, a statement of the applicant's revenues and expenses; and a detailed description of any transactions between the applicant and its donors or related entities. *See* I.R.S. FORM 1023-EZ UPDATE REPORT, *supra* note 16, at 6. The Service grants exemption less frequently (78.5% of Form 1023-EZ applications) when additional information is requested than for applications not subject to predetermination review (94.4% of Form 1023-EZ applications). *See id.* at 7 tbl.7 and 4 tbl.4 (1,794 of the 2,283 applicants selected for predetermination review from July 1, 2014 through June 24, 2016 were granted exemption and 82,321 of the 87,157 applications closed from July 1, 2014 through June 24, 2016 were granted exemption).

[198] *See* I.R.S. Form 1023-EZ, Streamlined Application for Recognition of Exemption Under Section 501(c)(3) (Rev. June 2014), Part II, Line 5, Line 6 and Line 7; I.R.S. Form 1023, Application for Recognition of Exemption Under Section 501(c)(3) (Rev. Oct. 2013), Part III, Line 1 and Line 2a.

[199] *See* NAT'L TAXPAYER ADVOCATE, *Form 1023-EZ*, *supra* note 17, at 38 ("[W]hen EO fails to inspect articles of incorporation, it risks recognizing as IRC § 501(c)(3) organizations those that do not meet the legal requirements."). The National Taxpayer Advocate cites examples of organizations receiving exempt status using Form 1023-EZ, but that do not have articles of organization satisfying the operational test. One example in particular highlights the problem of relying on self-certifications of applicants for exemption determinations:

> [T]he IRS recognized as exempt a corporation whose articles are devoid of any purpose clause or description of current or planned activities (and do not allow any insight about

My review of applicants who have been denied exempt status based on failure to meet the organizational test shows that provisions that state the organization may engage in any lawful activity or for any lawful purpose are considered grounds for denial by the Service because the organizational documents do not properly limit the organization's purposes and activities to exempt ones. But, these provisions allowing a corporation to engage in any lawful activity or for any lawful purpose under the applicable state's corporation laws are quite common in form articles of incorporation available for that state. Many of the small organizations that will take advantage of the Form 1023-EZ presumptively will be operated by volunteers and likely will not seek professional advice in forming the organization or applying for recognition of tax-exemption. As a result, the volunteer organizers may rely on the form articles of incorporation available in their state to form the organization under their state corporation laws and improperly include a provision that allows the organization to engage in any lawful activity. Prior to the implementation of Form 1023-EZ, the Service would assist small organizations like this by requesting that the organization amend its articles of incorporation to limit its activities to those lawful activities in furtherance of the organization's exempt purposes.[200] Assuming no other issues with the applicant's proposed activities, the Service then was likely to grant exemption once the applicant amended its articles of incorporation.[201]

> what those activities may be), and contain the following dissolution clause: "Assets will be distributed to registrant of entity [individual taxpayer's name], if this nonprofit dissolves." Assets that are ultimately destined for the founder's or some other individual's pocket cannot be viewed as dedicated to an exempt purpose. Had EO reviewed these articles of incorporation before it conferred exempt status, it presumably would have required their amendment.

Id.

[200] Despite the provision of this assistance, the National Taxpayer Advocate reports that 8% of these organizations do not amend their articles of organization at the request of the Service and are still granted exemption based on self-certification of the applicant that the articles of organization have been amended. *Id.* at 40.

[201] Due to new procedures for processing Form 1023, the Service no longer requires the applicant to submit its amended articles of organization to the Service prior to issuance of the organization's determination letter. *See id.* at 39.

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However, with the Form 1023-EZ, this same problem will go undetected.[202] The applicant in good faith will likely certify that its organizational documents are in compliance with the requirements for exemption, not realizing that the broad authorization to engage in any lawful activity in its articles of incorporation is technically a violation of the operational test. Relying on this certification, the Service would grant exemption to this applicant. However, if the organization is later reviewed by the Service and it is discovered that the organization's articles of incorporation do not comply with the organizational test, the organization's exemption will be revoked retroactively to the date of its incorporation.[203] Thus, a problem that would have been identified early and easily corrected in the Form 1023 application process can now result in trap for the unwary for organizations using the Form 1023-EZ application process.

More troublesome is the applicant's certification of the applicant's satisfaction of the requirements of the operational test and the Service's reliance on this unsubstantiated certification. Over 95% of applicants who were denied exemption from 2004–2016 did not satisfy the requirements of the operational test or the prohibition on private inurement. Violation of the prohibition on private inurement and engagement in non-exempt commercial activities to a substantial degree are the reasons cited as to why over 85% of these applicants did not satisfy these requirements. However, both of these doctrines are difficult to understand, and the instructions provided to applicants in the Form 1023-EZ instructions provide limited explanation of

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[202] The National Taxpayer Advocate recommends a cost-effective and efficient solution:

> TAS evaluated articles of incorporation of a representative sample of approved Form 1023-EZ filers incorporated in the 20 states in which the Secretary of State maintains a website that permitted TAS to view legible copies of articles of incorporation at no charge to determine whether they meet the organizational test. Such review took about three minutes on average and identified a significant portion of organizations whose applications have been erroneously approved. It appears that reviewing an applicant's case file and its articles of incorporation and then requesting amendments to the articles of incorporation takes EO about an hour. This is a small price to pay to prevent waste, error, and abuse.

NAT'L TAXPAYER ADVOCATE, *Form 1023-EZ*, *supra* note 17, at 38.

[203] I.R.S. Rev. Proc. 2017-5, 2017-1 I.R.B. 230, Section 12.03 ("The revocation or modification of a determination letter may be retroactive if . . . the organization omitted or misstated material information. A misstatement of material information includes an incorrect representation or attestation as to the organization's organizational documents, the organization's exempt purpose, the organization's conduct of prohibited and restricted activities, or the organization's eligibility to file Form 1023-EZ.").

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the parameters of these doctrines.[204] Accordingly, Form 1023-EZ applicants, especially applicants operated by volunteers, will likely certify that they meet these requirements without a full understanding of whether their activities actually comply with these requirements. In the Form 1023 application process, the Service requires the applicant to substantiate these certifications with additional description of proposed transactions with insiders, additional description of its activities, and other documentation of these activities. It is through this substantiation that the Service can detect potential violations of the prohibition on private inurement or commerciality doctrines. However, with the Form 1023-EZ application, the Service receives no substantiation of these certifications to determine whether the applicant is in compliance.

In my review of the data set of 588 applicants who have been denied exemption, 390 (or 66.4%) of those applicants would have qualified to use the Form 1023-EZ application, assuming the applicants could satisfy the income and asset limitations to use Form 1023-EZ.[205] Without requiring substantiation of the certifications made by these applicants in the Form 1023-EZ, it is likely that these applicants would have been granted exemption under the streamlined process whereby the Service relies on the certifications

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[204] I.R.S. Instructions for Form 1023-EZ (Rev. Jan. 2017). The instruction for Part III, Line 3 explains the prohibition on private inurement as:

> An organization is not operated exclusively for one or more exempt purposes if its net earnings inure in whole or in part to the benefit of private shareholders or individuals. The term "private shareholder or individual" refers to persons who have a personal and private interest in the organization, such as an officer, director, or a key employee. Any amount of inurement may be grounds for loss of tax-exempt status.
>
> Note. Examples of inurement include the payment of dividends and the payment of unreasonable compensation to private shareholders or individuals.

Id. at 7. The Form 1023-EZ instructions also explain that the organization may not engage in a commercial trade or business as its primary purpose, but give no explanation with respect to distinguishing a trade or business substantially related to the organization's exempt purpose and one that is not. *Id.* ("A business activity is not substantially related to an organization's exempt purpose if it does not contribute importantly to accomplishing that purpose (other than through the production of funds). Whether an activity contributes importantly depends in each case on the facts involved.").

[205] Satisfaction of the income and asset limitations is difficult to determine from the facts presented in the denial letters as identifying information, including income amounts and asset amounts, are typically redacted. Of the applicants that would not have been eligible to use Form 1023-EZ, 116 provided credit counseling services, 30 operated churches, nine operated schools, three operated hospitals, and 21 were organized as supporting organizations.

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made by the applicant without investigation.[206] While a relatively small number in the abstract, as a percentage of applications resulting in denial of exemption, this finding is significant. Considering the popularity of the Form 1023-EZ[207] and the findings of the National Taxpayer Advocate that a

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[206] The National Taxpayer Advocate sharply criticized the use of Form 1023-EZ by the Service:

> Unlike Form 1023, Application for Recognition of Exemption Under Section 501(c)(3), Form 1023-EZ does not solicit any narrative of the organization's activities, any financial data, any substantiating documents, or any explanatory material. With the adoption of Form 1023-EZ, the IRS effectively abdicated its responsibility to determine whether an organization is organized and operated for an exempt purpose.
>
> Experience thus far with the "streamlined" application procedures that Form 1023-EZ exemplifies has not been encouraging:
>
> - IRS audits demonstrate that eight percent of Internal Revenue Code (IRC) § 501(c)(3) organizations do not make required changes to their organizing documents even after they attest they have done so;
> - The IRS's own analysis of a representative sample of Form 1023-EZ filers shows that the IRS approves a significant number of applications it would have rejected had the applications been subject to a slight amount of scrutiny;
> - TAS's analysis of a representative sample of Form 1023-EZ applicants whose applications were approved by the IRS shows that 37 percent were not, as a matter of law, IRC § 501(c)(3) organizations; and
> - The frequency at which IRC § 501(c)(3) organizations were referred to the Exempt Organization (EO) Examination function increased almost ninefold from FY 2014 to FY 2015.

NAT'L TAXPAYER ADVOCATE, *Form 1023-EZ*, *supra* note 17, at 36–37 (internal citations omitted). The Service responded to the report justifying the streamlined application and its resulting allocation of limited resources to audits of exempt organizations rather than initial determinations. The National Taxpayer Advocate responded:

> As the Tax Exempt and Government Entities division (TE/GE) acknowledges, the IRS intends to address the "perceived inadequate oversight" that stems from its new Form 1023-EZ procedures by shifting more resources to audits. This back-end, labor-intensive approach invites noncompliance, diverts tax dollars and taxpayer donations, and harms taxpayers that could have adjusted their organizing documents or the activities they pursued if the IRS had advised them of the need to do so from the outset. While audits serve a role in furthering taxpayer compliance, they are no substitute for preventive, front-end efforts to avoid compliance issues in the first place. Thus, the proposed 1023-EZ audit strategy is a misallocation of IRS resources and an unnecessary burden on compliant exempt organizations.

Id. at 37 (internal citations omitted).

[207] *See* I.R.S. FORM 1023-EZ UPDATE REPORT, *supra* note 16, at 2 (approximately 55% of new applications for exemption filed from July 1, 2014 through June 24, 2016 were filed using Form 1023-EZ).

significant number of applicants approved using Form 1023-EZ did not satisfy the organizational test,[208] the potential for use of the Form 1023-EZ to result in the grant of exemption to organizations which do not satisfy the five-part test for exemption cannot be dismissed.

While I am mindful of the limited resources of the Service to thoroughly review exemption applications, I believe modifications to the Form 1023-EZ are needed to protect the integrity of the process for determination of exemption. When a determination is made that an organization qualifies for exemption as a charitable organization, not only does such determination result in an exemption from federal income tax for the organization but also allows donors to deduct donations made to the organization as itemized charitable deductions, thus reducing the individual income tax liabilities of the donors.[209] Additionally, a determination that an organization qualifies for federal tax exemption as a charitable organization often results in automatic determinations that the organization is exempt from state income and sales taxes.[210] Failure to properly vet applicants for exemption diminishes the Service's role to enforce the laws applicable to exempt organizations, and as a result, may diminish the public's trust in the Service as an effective overseer of the charitable sector.[211]

The observations made by the National Taxpayer Advocate are a good start,[212] but additional changes should be considered to vet the most

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[208] Recent studies conducted by the National Taxpayer Advocate indicate that approximately a third of the sample of applicants using Form 1023-EZ should not have been granted exempt status. NAT'L TAXPAYER ADVOCATE, *MSP #19*, *supra* note 5, at 256–57 (26% of the 323 applicants sampled failed the operational test based on a review of the applicants' articles of incorporation); *Study of Taxpayers that Obtained Recognition as IRC § 501(c)(3) Organizations on the Basis of Form 1023-EZ*, NATIONAL TAXPAYER ADVOCATE 2015 ANNUAL REPORT TO CONGRESS, 1, at 11–14) (37% of the 408 applicants sampled failed the operational test based on a review of the applicants' articles of incorporation).

[209] *See* I.R.C. § 170.

[210] Yin, *supra* note 17.

[211] NAT'L TAXPAYER ADVOCATE, *MSP #19*, *supra* note 5, at 257–58, (claiming some state charity officials are warning potential donors to carefully scrutinize organizations receiving exemption determination using Form 1023-EZ and some institutional grantors treat these organizations as ineligible to receive the institution's grants).

[212] NAT'L TAXPAYER ADVOCATE, *Form 1023-EZ*, *supra* note 17, at 44 (recommending that the Form 1023-EZ include a narrative description of the applicant's actual proposed activities and a summary

problematic areas for compliance with the exemption requirements. To verify that the applicant complies with the organizational test, the Form 1023-EZ should be revised to require the applicant to upload a copy of the applicant's certified governing documents with the application. In a ten to fifteen minute review of the governing documents,[213] an examining agent can confirm that the organization has chosen a proper form of organization; the organization's stated purposes are in fact exempt purposes; the governing documents do not permit the organization to engage in impermissible activities; and the governing documents contain the required dissolution clause. Currently, the Form 1023-EZ only requires an applicant to check a box confirming that the organizational documents comply with each of these requirements, but, as noted by the National Taxpayer Advocate,[214] simply checking a box does not ensure compliance. Likewise, in my study of the applicants who have been denied exemption using the regular Form 1023, a significant number of applicants did not satisfy the organizational test. Knowing that the Form 1023 application is subject to individual review, one can presume that the applicants who were denied exemption in the study likely believed that their organizational documents complied with the requirements of the organizational test or that they did not fully understand the requirements of the organizational test despite the explanation of the requirements contained in the instructions to Form 1023.[215] As a result, relying on self-certification

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of the applicant's actual or forecasted revenues and expenses and require the applicant to submit its organizing documents with the Form 1023-EZ, except when available from the state online at no cost).

[213] *See id.* at 38 (noting that the National Taxpayer Advocate's review of organizational documents of Form 1023-EZ applicants included in its 2015 study averaged three minutes per review).

[214] *Id.* at 40–41.

> EO rejected 152 applications included in the pre-determination review sample because the organization was ineligible to apply using Form 1023-EZ (even though Form 1023-EZ applicants attest they have completed an Eligibility Worksheet included in the instructions to the form and are eligible to use the form), or because the organization did not respond to the request for additional information. It is possible that these applicants would qualify as IRC § 501(c)(3) organizations. However, as of March 27, 2015, EO had also identified 181 cases in which a review of the organization's articles of incorporation revealed that the applicant did not initially meet the organizational test, despite their attestations to the contrary.

Id. at 41 (internal citations omitted).

[215] I.R.S. Instructions for Form 1023 (Rev. June 2006), at 7–8.

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of applicants in this regard does not appear to be an effective way to ensure the requirement is met.

More problematic is the potential misunderstanding of the operational test and prohibition on private inurement by applicants who may file Form 1023-EZ. In my study of the applicants who were denied exemption using regular Form 1023, over 95% engaged in substantial private benefit, engaged in substantial commercial activity, or engaged in prohibited private inurement. Since the implementation of Form 1023-EZ, the Service has issued seven denial letters for applicants who used Form 1023-EZ to apply for tax exemption. Six of these seven applicants were determined to have conferred more than insubstantial private benefit[216] and one applicant was determined to be engaged in substantial commercial activity.[217]

The parameters of the requirements for insubstantial private benefit, insubstantial commercial activity and prohibited private inurement are difficult to ascertain, even for applicants who in good faith are attempting to comply with the requirements. The Form 1023-EZ does little to elicit responses from the applicant that may signal an issue with the applicant's compliance with these tests. The Form 1023-EZ asks the applicant to simply check a box certifying that the applicant "[e]nsure[s] that [its] net earnings do not inure in whole or in part to the benefit of private shareholders or individuals (that is, board members, officers, key management employees, or other insiders)," does "not further non-exempt purposes (such as purposes that benefit private interests) more than insubstantially," and will "not be organized or operated for the primary purpose of conducting a trade or business that is not related to [its] exempt purpose(s)."[218] No additional

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[216] *See* I.R.S. Priv. Ltr. Rul. 2016-41-026 (July 14, 2016) (organization's perks program resulted in private benefit to its members and private businesses); I.R.S. Priv. Ltr. Rul. 2016-36-046 (June 6, 2016) (provision of death benefits served the private interests of the organization's members); I.R.S. Priv. Ltr. Rul. 2016-32-023 (May 11, 2016) (organization operated to provide benefits only to tenants leasing space in a specified shopping center); I.R.S. Priv. Ltr. Rul. 2016-32-020 (May 11, 2016) (provision of death benefits served the private interests of the organization's members); I.R.S. Priv. Ltr. Rul. 2016-31-014 (May 5, 2016) (homeowners' association served the private interests of condominium owners); I.R.S. Priv. Ltr. Rul. 2016-14-038 (Jan. 4, 2016) (provision of death benefits served the private interests of the organization's members).

[217] *See* I.R.S. Priv. Ltr. Rul. 2017-06-019 (Nov. 18, 2016) (sole activity was operating a professional rodeo in a manner similar to a commercial enterprise).

[218] I.R.S. Form 1023-EZ (Rev. June 2014), Part III, Line 3.

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questions are posed regarding the applicant's compliance with the private benefit limitation or the commerciality doctrine. For private inurement compliance, the applicant is also asked whether the applicant compensates its officers, directors or trustees[219] and whether the applicant will engage in any financial transactions with its officers, directors or trustees or any entities they control.[220] It is not evident whether answering "yes" to either of these questions will trigger a more intensive review of the application by the Service. However, compensation of officers, directors and trustees and financial transactions with insiders are not per se prohibited under the private inurement doctrine.[221] And the Form 1023-EZ makes no effort to ascertain whether these transactions are reasonable, and thus permitted under applicable rules. It is clear that further development of these questions is necessary to determine whether the applicant complies with the private inurement prohibition.

Accordingly, the Form 1023-EZ should include additional questions to probe in more detail the applicant's compliance with the private benefit limitation, commerciality doctrine and prohibition on private inurement. Many of these additional questions can be adapted from Form 1023 and would likely add one or two pages to the existing Form 1023-EZ. For compliance with the private inurement prohibition, additional questions asking for the amount of compensation paid to each officer and director and how the amount of compensation was determined should be added similar to the information requested in Form 1023, Part V, Line 1a, Line 3 and Line 4.[222] Similarly, with respect to proposed financial transactions with insiders,

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[219] I.R.S. Form 1023-EZ (Rev. June 2014), Part III, Line 5.

[220] I.R.S. Form 1023-EZ (Rev. June 2014), Part III, Line 8.

[221] Generally, transactions between a charitable organization and its insiders are permitted as long as the transactions are reasonable and do not provide excessive benefit to the organization's insiders. *See* I.R.C. § 4948(c)(1) (defining "excess benefit" as any transaction in which the organization does not receive an economic benefit equal to or more than the economic benefit received by the organization's insiders).

[222] I.R.S. Form 1023, Application for Recognition of Exemption Under Section 501(c)(3) (Rev. Oct. 2013). Part V, Line 1a, Line 3 and Line 4:

> 1a List the names, titles, and mailing addresses of all of your officers, directors, and trustees. For each person listed, state their total annual compensation, or proposed compensation, for all services to the organization, whether as an officer, employee, or other position.

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the applicant should be asked to explain the key terms of the financial transaction, how the transaction was negotiated at arm's length and how the applicant determined that the insider received no more than fair market value for the benefit conferred by the applicant. Form 1023, Part V, Line 7 and Line 8 can be used as templates to design these questions.[223]

. . . .

3a For each of your officers, directors, trustees, highest compensated employees, and highest compensated independent contractors listed on lines 1a, 1b, or 1c, attach a list showing their name, qualifications, average hours worked, and duties.

3b Do any of your officers, directors, trustees, highest compensated employees, and highest compensated independent contractors listed on lines 1a, 1b, or 1c receive compensation from any other organizations, whether tax exempt or taxable, that are related to you through common control? If "Yes," identify the individuals, explain the relationship between you and the other organization, and describe the compensation arrangement.

4 In establishing the compensation for your officers, directors, trustees, highest compensated employees, and highest compensated independent contractors listed on lines 1a, 1b, and 1c, the following practices are recommended, although they are not required to obtain exemption. Answer "Yes" to all the practices you use.

a Do you or will the individuals that approve compensation arrangements follow a conflict of interest policy?

b Do you or will you approve compensation arrangements in advance of paying compensation?

c Do you or will you document in writing the date and terms of approved compensation arrangements?

d Do you or will you record in writing the decision made by each individual who decided or voted on compensation arrangements?

e Do you or will you approve compensation arrangements based on information about compensation paid by similarly situated taxable or tax-exempt organizations for similar services, current compensation surveys compiled by independent firms, or actual written offers from similarly situated organizations?

f Do you or will you record in writing both the information on which you relied to base your decision and its source?

g If you answered "No" to any item on lines 4a through 4f, describe how you set compensation that is **reasonable** for your officers, directors, trustees, highest compensated employees, and highest compensated independent contractors listed in Part V, lines 1a, 1b, and 1c.

Id.

[223] I.R.S. Form 1023, Application for Recognition of Exemption Under Section 501(c)(3) (Rev. Oct. 2013). Part VI, Line 7 and Line 8:

More information about compliance with the private benefit limitation can be gathered by adapting the questions posed on Form 1023, Part VI, Lines 2 and Line 3.[224] These questions ask whether the organization limits

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> 7a Do you or will you purchase any goods, services, or assets from any of your officers, directors, trustees, highest compensated employees, or highest compensated independent contractors listed in lines 1a, 1b, or 1c? If "Yes," describe any such purchase that you made or intend to make, from whom you make or will make such purchases, how the terms are or will be negotiated at arm's length, and explain how you determine or will determine that you pay no more than fair market value. Attach copies of any written contracts or other agreements relating to such purchases.
>
> b Do you or will you sell any goods, services, or assets to any of your officers, directors, trustees, highest compensated employees, or highest compensated independent contractors listed in lines 1a, 1b, or 1c? If "Yes," describe any such sales that you made or intend to make, to whom you make or will make such sales, how the terms are or will be negotiated at arm's length, and explain how you determine or will determine you are or will be paid at least fair market value. Attach copies of any written contracts or other agreements relating to such sales.
>
> 8a Do you or will you have any leases, contracts, loans, or other agreements with your officers, directors, trustees, highest compensated employees, or highest compensated independent contractors listed in lines 1a, 1b, or 1c? If "Yes," provide the information requested in lines 8b through 8f.
>
> b Describe any written or oral arrangements that you made or intend to make.
>
> c Identify with whom you have or will have such arrangements.
>
> d Explain how the terms are or will be negotiated at arm's length.
>
> e Explain how you determine you pay no more than fair market value or you are paid at least fair market value.
>
> f Attach copies of any signed leases, contracts, loans, or other agreements relating to such arrangements.

Id.

[224] I.R.S. Form 1023, Application for Recognition of Exemption Under Section 501(c)(3) (Rev. Oct. 2013). Part VI, Line 2 and Line 3:

> 2 Do any of your programs limit the provision of goods, services, or funds to a specific individual or group of specific individuals? For example, answer "Yes," if goods, services, or funds are provided only for a particular individual, your members, individuals who work for a particular employer, or graduates of a particular school. If "Yes," explain the limitation and how recipients are selected for each program.
>
> 3 Do any individuals who receive goods, services, or funds through your programs have a family or business relationship with any officer, director, trustee, or with any of your highest compensated employees or highest compensated independent contractors listed in Part V, lines 1a, 1b, and 1c? If "Yes," explain how these related individuals are eligible for goods, services, or funds.

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the provision of its programs to a specific individual or group of individuals or whether persons receiving services from the organization have a family or business relationship with the organization's officers or directors. A "yes" answer to either of these questions would warrant further inquiry as potential private benefit may exist from not benefiting a charitable class, from serving only the members of the organization, or from serving the private interests of the organization's insiders. As the Form 1023-EZ currently stands, there is nothing to indicate whether an examining agent should be concerned with potential private benefit; yet, private benefit was an area of substantial noncompliance among the applicants who were denied tax-exempt status in my study.

Finally, the Form 1023-EZ does little to ascertain whether the applicant conducts a trade or business in a manner that violates the commerciality doctrine. Aside from the self-certifying statement that the applicant does not primarily conduct a non-exempt purpose, the only other question of Form 1023-EZ related to the conduct of a trade or business asks whether the applicant will have more than $1,000 in unrelated business gross income.[225] Among the applicants who were denied exempt status examined in my study, substantially all of applicants that violated the commerciality doctrine believed the trade or business activity in question was related to a recognized exempt purpose. It was through development of the application by an examining agent that it was determined the trade or business in question was not an exempt activity and was conducted in a commercial manner. Accordingly, applicants who do not understand the requirements of the limitation on commercial activity will likely certify that they do not conduct an unrelated trade or business and also do not expect to receive significant revenue from an unrelated trade or business. Commercial activity would go undetected with Form 1023-EZ applicants unless discovered through a random selection of the applicant; there would be no indication on the form itself that further questions in this area should be asked. Including a series of "yes" or "no" questions related to the factors most often cited by the Service to determine that an applicant has violated the commerciality doctrine would go a long way in signaling whether further development of the application by an examining agent is warranted. For example, the applicant can be asked

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Id.

[225] I.R.S. Form 1023-EZ, Part III, Line 9.

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whether its goods or services are provided at or below cost; whether the applicant will advertise the availability of its goods or services; whether for-profit organizations in the area provide similar goods or services; and whether the applicant will receive donations, grants or other forms of public support to assist the applicant with the provision of its goods or services. Violation of the commerciality doctrine was a primary reason cited for failure to meet the operational test in the denial letters examined in my study; failure to gather any information on an applicant's compliance with the commerciality doctrine on Form 1023-EZ provides a large opportunity for organizations not deserving of exemption to slip through the system undetected.

CONCLUSION

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. The Service appears firmly entrenched in the "primary purpose" test in evaluating potential commercial activity of applicants and has nearly abandoned the "commensurate in scope" test.

In addition, a substantial percentage of applicants violated the prohibition on private inurement. 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. The wisdom of the Service enforcing governance practices in this manner has been criticized,[226] and it would be helpful for the Service to issue published guidance describing its requirements in this area. This would allow applicants to understand the governance requirements imposed by the Service and prevent the Service from applying varying ad hoc requirements to similar situations.

[226] *See generally* Fishman, *supra* note 12, at 545 (critiquing the shift of enforcement of corporate governance of charitable organization to the Service from state regulators with no statutory authority to mandate the Service corporate governance recommendations).

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A substantial percentage of applicants conducted activities which conferred more than insubstantial private benefit. These determinations are difficult to make without a full understanding of the applicant's purposes and proposed activities. The new streamlined Form 1023-EZ will exasperate the instances of exempt organizations conferring impermissible private benefit as the form requests nothing more than a self-certifying statement that the applicant does "not further non-exempt purposes (such as purposes that benefit private interests) more than insubstantially."[227] With the number of Form 1023-EZ applicants in the first year of the form's introduction nearing the total Form 1023 applications approved in fiscal year 2013 and the number of Form 1023-EZ applicants exceeding Form 1023 applicants in fiscal year 2015 and fiscal year 2016, the implications of the Service's non-review of the private benefit limitation (and to the same degree the commerciality doctrine and private inurement doctrine) for Form 1023-EZ applicants are potentially great. As the National Taxpayer Advocate reports, exemption has been granted to Form 1023-EZ applicants that clearly violate the private benefit limitation and which a cursory review of the applicant's articles of organization and proposed activities would reveal.[228] Further, post-determination review in the form of audits of Form 990 likely will not catch instances of substantial private benefit conferred by small charities because these organizations are required to provide only cursory information about their activities on Form 990-N on an annual basis.[229] Accordingly, required reporting by the organization is unlikely to reveal any basis on which to question the organization's provision of private benefit as justification to initiate an audit.

In my next study, I will review determination letters over the same time period which revoke the exempt status of organizations previously recognized as charitable organizations described in Section 501(c)(3). Using the same criteria to review these determination letters, I will assess whether the Service varies its factors used in determining whether an organization

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[227] I.R.S. Form 1023-EZ, Streamlined Application for Recognition of Exemption Under Section 501(c)(3) (Rev. June 2014).

[228] *See* NAT'L TAXPAYER ADVOCATE, *Form 1023-EZ*, *supra* note 17, at 38.

[229] *See* I.R.S., *Information Needed to File e-Postcard* (Rev. Jul. 20, 2016), https://www.irs.gov/charities-non-profits/information-needed-to-file-e-postcard. The information required to be reported on Form 990-N includes the organization's name, employer identification number, address, tax year and web address, and the name and address of a principal officer of the organization. *Id.*

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satisfies the four tests for exemption depending on the organization's status as an applicant or an existing exempt charity. For example, the Service examines governance practices of substantially all of the applicants determined to have engaged in private inurement. Will the Service scrutinize the governance practices of existing exempt charitable organizations to the same degree and using the same best practices criteria as it does for applicants? In addition, exempt organizations who receive notice that their exempt status has been revoked are more likely to seek judicial review of these determinations than applicants who are denied exempt status. Accordingly, my next study will also examine court cases that consider the appeal of the Service's revocation of the organization's exempt status. From the review of these cases, I can determine whether the court views any factors considered by the Service as improper, and then consider whether the Service continues to consider such factors in its review of applications for exemption. This combined data set will provide a rich resource for researchers to assess the feasibility of the five-part test for exemption and to make recommendations, whether statutory or regulatory, for improving the exemption criteria and the Service's application of the exemption criteria to charitable organizations.

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