Bond Case Briefs

Municipal Finance Law Since 1971

Blame It on the ROO: Form 1023-EZ and Decline of EO Determinations.

Brad Bedingfield discusses the future role of the IRS Review of Operations Unit within the exempt organizations division.

With the development of streamlined procedures for processing applications for tax-exempt status, including the new Form 1023-EZ, the IRS EO division appears to be moving toward a self-certification system. The success of that strategy will depend largely on how well the IRS can strengthen its examination programs, including its Review of Operations Unit, also known as the "ROO."

* * * * *

Lois Lerner's now infamous comments at a May 10, 2013, conference regarding the handling of Tea Party applications for tax-exempt status may have marked the beginning of the end for the IRS exempt organizations determinations function. What had been a gradual shift of resources from review of initial applications to later examinations is quickly becoming a landslide. When the dust settles, many organizations seeking exempt status may enjoy something very close to a self-certification system. Whether that shift blows open the doors for bad actors to claim exempt status under false pretenses may depend largely on the success of a small and little-known program within the EO division, which may now morph (in some form) into one of its most important: the IRS Review of Operations Unit, also known as the "ROO."

What Is the ROO?

The ROO began in 2005, on the recommendation of the IRS Advisory Committee on Tax Exempt and Government Entities.1 At the heart of the ROO was a recognition that not every organization is entirely truthful in its initial application and that many organizations — even "good" ones — evolve significantly in their early years. EO determinations specialists have suspicions that an applicant isn't telling the whole story. They have a mechanism for asking for additional information: the so-called development letter.2 However, development letters are intended to solicit information necessary to make a determination, not to stress test an organization's representations or to catch organizations in a lie. A determinations specialist is generally reviewing an organization before it's really done anything. What if there is reason to suspect that an applicant may not really intend to operate for exempt purposes but there is no track record of activity to allow the specialist to prove it?

Since 2005 a determinations specialist has the option of approving an application subject to a ROO referral.3 The applicant receives its exemption letter, but behind the scenes its file is sent to a team of specialists, who, after a few years have passed, perform a "no-contact" review of the organization (as opposed to a compliance review or correspondence examination, which involve remote correspondence with the organization, or a field examination, which may involve an on-site review4). The organization has no way of knowing (without access to the IRS's internal file5) whether it is

under ROO review. A ROO specialist will look at the first few years of annual returns (Form 990, 990-EZ, 990-PF, or 990-N) and at whatever information is publicly available regarding the organization, including information on its website. The specialist will then compare that information with the original application for recognition of exempt status. If there are inconsistencies or other causes for concern, the specialist may refer the case for further examination.

Why Expand It?

In the wake of the Tea Party scandal, the IRS hired "Lean Six Sigma" consultants to review the internal processes and workflow systems of the EO division.6 Those consultants identified various inefficiencies in the current determinations process, in part attributable to the fact that the IRS traditionally has tried to provide substantial review of purportedly EOs both on the front end — through the determinations process — and on the back end — through examinations.7 Whether an organization is exempt often depends on multiple facts and circumstances tests, which require significant time and resources to review adequately. At the same time, an effective examinations program arguably requires auditing a sufficient percentage of organizations to discourage others from playing the audit lottery. However, only a very small percentage of EOs get audited every year.8 By trying to catch bad actors on both the front end and the back end, dwindling IRS resources are doubly stretched, and more and more organizations slip through the cracks altogether.

This resource crunch is nothing new to the IRS, although it has been particularly acute in recent years. The EO division has long tried to find more efficient ways to catch bad actors while allowing good charities to get on with their programs. In recent years, it has experimented with special compliance projects, the development of risk analytics, and tiered determinations processing.9 In its determinations function, the IRS created teams of specialists to handle specific kinds of cases more efficiently, and it developed tracking and processing systems (such as the ill-fated "be on the lookout," or BOLO list) to direct cases to specialists. In the meantime, however, resources continued to dwindle, even as Congress added new duties, such as offshore account initiatives, the Affordable Care Act, and auto-revocation.

With dwindling resources on both the determinations side and the examinations side, the ROO, which sits somewhere between the two,10 is an attractive option. Inefficiencies on the determinations side are particularly problematic because the more time specialists spend pushing back on unqualified applicants, the more time other organizations have to wait in line for recognition of exempt status. Since 2010, when a massive influx of auto-revocation reinstatement cases flooded the system, many organizations now wait more than a year just to be assigned to a determinations specialist, and enough cases are taking multiple years to process that the IRS has had to issue guidance on what to do about organizations that are automatically revoked for failure to file annual returns for three years while awaiting review of their applications.11 Offloading that time-consuming initial review to the ROO would, in theory, allow the "good" organizations to get their exemption letters and get on with their charitable programs, while shifting the initial filtering process just a few years down the road, when the IRS can test organizations against actual activities, not just representations.

Will It Work?

The IRS is clearly betting that it will work. When it recently began allowing section 501(c)(4) applicants to attest that they would not engage in more than a designated amount of political activity, in lieu of full case development on that issue during the application process, the IRS signaled that reliance on attestations might be supplemented by a ROO referral.12 More recently, the IRS has been developing a more streamlined application process for section 501(c)(3) applicants, including a new Form 1023-EZ for some smaller organizations,13 and reliance on attestations rather

than full development for many other applicants.14 IRS officials have stated that they intend to balance those streamlined application procedures with a more "robust compliance process on the back end."15

Form 1023-EZ appears to contemplate possible ROO referrals for some organizations. Part III, in particular, asks a series of questions (lines 4 through 11) regarding potential activities, including payment of compensation, international activity, lobbying activity, and specified financial transactions.16 According to the Instructions for Form 1023-EZ, the answers to those questions do not affect eligibility to file the form.17 Organizations that answer yes to any of those questions are not asked for additional information, as they would be in a traditional Form 1023 application. What, then, is the purpose of the questions? It seems likely that at least one purpose is to generate data that may be used in deciding which organizations will receive a ROO or other examination referral.18

If the IRS does intend to rely heavily on the ROO, the agency will certainly need to expand it. As of September 2012, there were only 40 ROO specialists.19 Presumably, more will be needed to provide a meaningful backstop to the more than 60,000 applications the IRS receives each year. IRS officials have indicated that once the new streamlined application procedures are in place and the current backlog of applications has been addressed, determinations personnel will likely be reassigned to examinations (which includes the ROO).20

Also, the IRS will need to tighten its internal documentation and processes regarding ROO referrals and processing. In theory, at least some ROO referrals are randomly selected.21 However, it appears that many organizations may have historically been chosen for ROO referral based on a particular specialist's gut reaction to the organization's application.22 For this reason, the ROO has been criticized as prone to abuse — indeed, the House Ways and Means Committee recently called out the ROO (to which many Tea Party applications were referred) as the IRS's "surveillance program."23 Unless the IRS has sufficient resources to require a ROO referral for all organizations claiming tax-exempt status (or at least for all Form 1023-EZ filers), it will need to develop and publish objective criteria for determining what organizations get referred to the ROO, and it may need to combat the surveillance program characterization somewhat by at least informing organizations that they are or have been subject to the ROO.

However, even the most robust and transparent ROO program will not result in review of new EOs until some time after they have received exemption letters. Many governmental and other organizations, in granting tax preferences or otherwise in dealing with new EOs, rely to some extent on the fact that the IRS has performed some sort of meaningful initial review, and they have criticized the new streamlined processes as diluting the weight that an IRS exemption letter now may carry (at least in an organization's first few years).24 State officials and others are understandably concerned that shifting review to the ROO or other examination program will open the floodgates for purported EOs that might not have survived the traditional IRS application process.

It remains to be seen whether the IRS will find a way to filter out at least some of the unqualified applications upfront. Form 1023-EZ, unlike Form 1023, must be electronically filed. Electronic filing could in theory give the IRS an increased opportunity to educate applicants regarding the requirements for tax exemption as they complete the application, and perhaps the opportunity to weed out some applications through an interactive application process. The electronic Form 1023-EZ does not, however, appear to include such interaction between the Form and the Instructions. The IRS has estimated that organizations will take an average of 8.9 hours to complete the 2 1/2-page Form 1023-EZ.25 That estimate assumes that applicants will spend substantial time reviewing the Instructions in a good-faith attempt to understand the requirements for exempt status. That

assumption may be naïve, however, and it does not account for the bad-faith attempt by organizations to take advantage of the lack of initial review.

Moreover, it is not yet clear what the consequences will be for an organization that incorrectly files a Form 1023-EZ.26 Some organizations may violate the filing criteria inadvertently. For example, the Form 1023-EZ Instructions preclude an organization with more than $50,000 of annual revenue in its early years from using the form. What if the organization is more successful in its early fundraising than anticipated? Will its exempt status be revoked? Will its initial exemption letter be viewed as somehow contingent on continued compliance (at least during the first few years) with the Form 1023-EZ filing criteria? What about organizations that never intended to comply with the filing criteria? The threat of revocation, even retroactive revocation, will unlikely be a sufficient deterrent. Will the IRS actively pursue fraud or criminal penalties against enough bad-faith applicants to provide a meaningful chilling effect? The ultimate success of the streamlined application process and consolidation of resources on the examinations side will depend not just on beefing up the ROO or other examination programs but also on finding some way at least to limit the perception that bad actors are likely to get away with disingenuous Form 1023-EZ filings.

What Should We Expect?

At first blush, it appears that the universe of organizations that can file Form 1023-EZ is relatively small. An organization that anticipates more than $50,000 in annual revenue, or $250,000 in assets, in its early years doesn't qualify.27 Also excluded are supporting organizations, sponsors of donor-advised funds, schools, churches, and many others.28 When submitting a prior draft Form 1023-EZ to the Office of Management and Budget for its review, the IRS stated that it expected only about 17 percent of applicants will use the form.29 However, that draft provided significantly higher filing thresholds ($200,000 in annual revenue and $500,000 in assets). With the lower thresholds, the initial percentage may be lower.

However, the IRS may allow Form 1023-EZ to eventually be used by a much higher percentage of applicants. TE/GE Commissioner Sunita Lough has indicated that the filing criteria are not "cut in stone," and that perhaps as many as 70 percent of applicants may eventually use this form.30 Further, it appears that many Form 1023 applications will rely more on attestations than traditional case development at the determinations stage.31 Therefore, it seems likely that an ever-increasing percentage of organizations will receive exemption letters without significant upfront review.

What Should We Do?

If an organization clearly meets the Form 1023-EZ criteria and is willing to monitor with special care its annual returns, its website, and other public activity in its first five years, the lure of Form 1023-EZ is compelling. Instead of the current long wait times — even for many simple applications — organizations could get their exemption letters in "weeks rather than months" (or years).32 The ability to get an exemption letter and begin activities quickly can make all the difference to a young organization trying to jump-start its charitable programs.

However, an organization that (1) has any doubt about whether it will meet the Form 1023-EZ filing criteria in its early years; (2) must answer yes to any of the questions in Part III, lines 4 through 11; or (3) is concerned about the weight that state officials or others may give to an "EZ" determination letter may want to file a full Form 1023 application. It can be difficult to wait months or years for a determination. However, the IRS has committed to (eventually) processing all applications in six months or less, and because of the heavy backlog over the past several years, applicants have learned various methods (such as fiscal sponsors) to begin their charitable activities to some extent while waiting for a determination.

As of July 1, 2014, Form 1023-EZ is ready for electronic filing. It will be interesting to see how many organizations file the new form, and to what extent fear of the ROO can keep these new EOs in line.

FOOTNOTES

1 See Treasury Inspector General for Tax Administration, "Performance Measures and Improved Case Tracking Would Help the Exempt Organizations Function Better Allocate Resources" (Mar. 13, 2008) 2008 TNT 58-21: Treasury Reports.
2 See Internal Revenue Manual section 7.29.3.2.1.

3 See IRM section 7.20.1.5.2. The ROO also monitors organizations denied exemption to ensure that they are not holding themselves out as exempt. See IRM section 7.20.1.5.2(2).

4 See IRM section 4.75.27. See also IRS EO division, "FY 2012 Annual Report & FY 2013 Workplan," at 5 (Jan. 25, 2013) 2013 TNT 18-57: Other IRS Documents (fiscal 2012 report).

5 Specifically, Form 14266, which documents the reasons for the ROO referral.

6 Lean Six Sigma is a management re-engineering method used to optimize business performance.

7 See IRS EO division memorandum, "Streamlined Processing Guidelines for All Cases" (Feb. 28, 2014) 2014 TNT 46-64: Other IRS Documents.

8 See fiscal 2012 report, supra note 4, at 5.

9 Id.

10 The ROO is technically part of the IRS Exempt Organizations Compliance Area, a subdivision of EO Examinations. Id. at 2.

11 See IRS EO division memorandum, "Processing Guidelines for Certain Pending Applications of Exempt Organizations That Fail to File Annual Information Returns for Three Consecutive Years" (Mar. 14, 2014) 2014 TNT 59-31: Other IRS Documents.

12 See IRS EO division memorandum, "Interim Guidance on Optional Expedited Process for Certain Exemption Applications Under Section 501(c)(4)" (June 25, 2013) 2013 TNT 125-55: Other IRS Documents; IRS EO division memorandum, "Amendment to Interim Guidance on Optional Expedited Process for Certain Exemption Applications Under Section 501(c)(4)" (July 18, 2013) 2013 TNT 140-50: Other IRS Documents; and IRS EO division memorandum, "Expansion of Optional Expedited Process for Certain Exemption Applications Under Section 501(c)(4)" (Dec. 23, 2013).

13 See Form 1023-EZ; and Instructions for Form 1023-EZ (rev. June 2014) 2014 TNT 127-51: Forms Watch.

14 See "Streamlined Processing Guidelines," supra note 7.

15 See EO Tax Journal 2014-83; Diane Freda, "IRS to Roll Out Form 1023-EZ in Summer, Anticipates Little Risk of Noncompliance," Bloomberg BNA (Apr. 25, 2014) (reporting on an April 23 media call with IRS TE/GE Commissioner Sunita Lough); and John Koskinen, testimony on the fiscal 2015 IRS budget, at 11 (Apr. 7, 2014) 2014 TNT 67-31: IRS Testimony.

16 See Form 1023-EZ, supra note 13.

17 See Instructions for Form 1023-EZ, supra note 13.

18 Moreover, these questions may make it easier for the IRS to revoke the organization's exempt status, perhaps retroactively, if an organization's actual activities are inconsistent with these representations.

19 See fiscal 2012 report, supra note 4, at 12.

20 See supra note 15.

21 See fiscal 2012 report, supra note 4, at 12 (describing the ROO as consisting of "randomly selected follow-ups").

22 See IRM section 7.20.1.5(2)(B) ("A Review of Operations (ROO) follow-up referral is prepared when a determination specialist has concerns about the past, present, or future activities of the organization but does not have sufficient cause to deny exemption"); and IRM section 7.20.1.5.2 ("ROO follow-up referrals should be made for material issues when questionable activity is likely to occur, e.g., future operations may impact exempt status, generate UBI or other tax liabilities, or necessitate a change in private foundation classification").

23 See Ways and Means Committee letter to Attorney General Eric Holder, at 7 (Apr. 9, 2014) 2014 TNT 69-26: Congressional Tax Correspondence.

24 See, e.g., National Association of State Charity Officials, comments on proposed Form 1023-EZ (Apr. 30, 2014), available at http://www.nasconet.org/nasco-submits-comment-on-proposed-form-1023-ez/; and http://www.councilofnonprofits.org.

25 See Instructions for Form 1023-EZ, supra note 13, at 10.

26 See Rev. Proc. 2014-40, section 8.02.

27 See Instructions for Form 1023-EZ, supra note 13.

28 Id.

29 See draft Instructions for Form 1023-EZ (Feb. 10, 2014).

30 See EO Tax Journal 2014-83, supra note 15; and Fred Stokeld, "Streamlined Exemption Application Could Pose Compliance Problems," Tax Notes, Apr. 28, 2014, p. 439 2014 TNT 76-7: News Stories (reporting on April 23 telephone remarks by Lough).

31 See supra note 12.

32 Koskinen testimony, supra note 15, at 11.

END OF FOOTNOTES

By Brad Bedingfield

Brad Bedingfield is an attorney with Goulston & Storrs PC in Boston and a former tax law specialist in the IRS Exempt Organizations division.

Copyright © 2026 Bond Case Briefs | bondcasebriefs.com