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States as Laboratories for Charitable Compliance: An Empirical Study

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STATES AS LABORATORIES FOR CHARITABLE COMPLIANCE: AN EMPIRICAL STUDY

Eric Franklin Amarante

ABSTRACT

Each year, the IRS awards 501(c)(3) status to thousands of unworthy organizations. As a result, these undeserving organizations do not have to pay federal taxes and donations to these entities are tax-deductible. This is because the IRS, facing increasingly severe budget cuts, adopted a woefully inadequate application process that fails to identify even the most obvious of unworthy applicants. The result of this regulatory failure may prove to be catastrophic. As unworthy charities proliferate, the public will lose faith in the entire charitable regime. As trust dissipates, donations are certain to follow, and the charitable sector will lose a vital revenue stream. It is not an exaggeration to say that the loss of donations represents an existential threat to the entire charitable sector.

With a change in budgetary priorities unlikely in the foreseeable future, it would be unwise to wait for the IRS to curb this threat. Rather, it would be prudent to identify another way to increase regulatory compliance in the charitable sector. This article proposes a cost-efficient mechanism for states to fill the regulatory void left by the IRS. To identify this mechanism, this study reviewed 500 formation documents in five different states, identifying the state procedures that resulted in the highest level of regulatory compliance. By replicating the procedures identified in this article, individual states will not only ensure higher levels of regulatory compliance, but also help restore the public's trust in the charitable sector.

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INTRODUCTION 3
I. OUR FAILURE TO REGULATE CHARITIES 6
A. *The First Step: Formation* 7
B. *The Second Step: Applying for Tax-Exempt Status* 15
1.The Streamlined Application 16
2.Criticisms of the Streamlined Application 18
II. THE HARMS OF UNREGULATED CHARITY 22
A. *A Tarnished Halo* 22
B. *Leaving Charities Vulnerable to Attack* 24
III. THE DATA 25
A. *Study Methodology* 27
1. IRS Publication of Streamlined Application Data 27
2.Choosing the States for the Study 29
3.Determining the Sample 31
B. *The Data* 31
1.Florida: The Sunshine State 31
2.Idaho: The Gem State 34
3.Maryland: The Old Line State 37
4.North Carolina: The Tar Heel State 39
5.Ohio: The Buckeye State 43
6.Summary of Findings 46
IV. LESSONS FROM THE DATA 47
CONCLUSION 52

Electronic copy available at: https://ssrn.com/abstract=3814958

INTRODUCTION

Why do we give to charities?[1] One is tempted to point to our tax code's financial incentive to give,[2] but this cannot be the only reason because many people give to charity without taking advantage of any tax benefits.[3] Scholars have offered numerous additional justifications for our generosity, including the "desire to win prestige, respect, [or] friendship,"[4] "social pressure, guilt, [or] sympathy,"[5] and the "desire to avoid scorn."[6] These justifications have an intuitive appeal, but they miss the point of charitable giving. Ask most donors, and they are likely to tell you they are not driven by tax considerations, status, or social pressures. Rather, they give because they are "motivated by the intrinsic pleasure associated with a particular form of prosocial behavior."[7] Or to say it plainly, people donate because it feels good. Economists call this the "warm glow"[8] effect of charitable giving, an effect so powerful that it might be the primary motivation people give to charity.[9]

But the warm glow is under threat. If we cannot trust charities to use our donations for good deeds—if, for example, a charity used donations to throw lavish private parties or line the pockets of the founders—the ineffable warm glow would certainly dissipate. More than any other type of organization, charities rely upon the confidence and trust of the general public for their continued existence, and to the extent the general public loses faith in the charitable sector, donations of time and money are unlikely to continue. In

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[1] Eric Franklin Amarante, *The Perils of Philanthrocapitalism*, 78 MARYLAND LAW REV. 1, 11 (noting that Americans donate more to charity than almost any other nation (citing LESTER M. SALAMON, AMERICA'S NONPROFIT SECTOR: A PRIMER 72 (3d ed. 2012))). Throughout this Article, "charity" and "charitable status" will refer to public charities described in § 501(c)(3) of the Internal Revenue Code of 1986, as amended.

[2] Donations to 501(c)(3) organizations are tax-deductible. I.R.C. § 170(b)(1)(vii). The amount of the deduction is limited to a percentage of the donor's adjusted gross income and dependent on whether the tax-exempt entity is a public charity or a private foundation.

[3] *See Briefing Book*, TAX POL'Y CTR., https://www.taxpolicycenter.org/briefing-book/what-areitemized-deductions-and-who-claims-them [https://perma.cc/YF9Z-469R] ("In recent years about 30 percent of taxpayers, mostly high income, have chosen to itemize, but increases in the standard deduction and limits to itemized deductions starting in 2018 will greatly reduce the number of itemizers.").

[4] MANCUR OLSEN, THE LOGIC OF COLLECTIVE ACTION (Harvard 1965)

[5] James Andreoni, *Impure Altruism and Donations to Public Goods: A Theory of Warm-Glow Giving*, 100 THE ECONOMIC JOURNAL 464 (June 1990).

[6] Gary S. Becker, *A Theory of Social Interactions*, 82 J. POL. ECON. 1063 (1974)

[7] Özgür Evren and Stefania Minardi, *Warm-Glow Giving and Freedom to be Selfish*, 127 THE ECONOMIC JOURNAL 1381 (2017).

[8] Usha Rodrigues, *The Power of Warm Glow*, 88 TEXAS LAW REVIEW *SEE ALSO* 149, 151 (2010) (defining "warm glow" as "a specific kind of utility that comes from giving.").

[9] *Id*. at 153 ("Even in a tax-neutral world, at least some nonprofits would continue to flourish because they offer a special kind of warm glow….").

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other words, if the general public has reason to doubt that our charities are, for lack of a better word, *charitable*, then the entire sector faces an existential threat.

Unfortunately, this existential threat is upon us. Due to severe underfunding,[10] the IRS is no longer able to either assess the worthiness of aspiring tax-exempt charities or monitor the activities of existing charities.[11] This failure is most evident in the IRS's decision[12] to implement a streamlined application for tax-exempt status (the "Streamlined Application").[13] Designed to address an embarrassingly large backlog of tax-exempt applications,[14] the Streamlined Application elicits so little information[15] that at least one commentator could credibly quip that "it takes more to get a library card than it takes to get this new exempt status."[16] An insufficient application process might be acceptable if the IRS properly monitored charities, but the tool to monitor most charities is similarly insufficient.[17] Ultimately, our country has a meaningless tax-exempt application process and a toothless monitoring regime, a combination

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[10] *See* Paul Kiel & Jesse Einsinger, *How the IRS Was Gutted*, PROPUBLICA, Dec. 11, 2018 *available at* https://www.propublica.org/article/how-the-irs-was-gutted [https://perma.cc/QTA2-6385]

[11] *See generally* Internal Revenue Service, Pub. No. 557, Tax Exempt Status For Your Organization (2008), *available at* www.irs.gov/pub/irs-pdf/p557.pdf. Interestingly, it is not clear that role was ever considered by Congress. *See* Lloyd Hitoshi Mayer and Brendan M. Wilson, *Regulating Charities in the Twenty-First Century: An Institutional Choice Analysis*, 85 CHICAGO KENT LAW REVIEW 479, 498 (2010) (noting that "it is generally recognized that Congress … did not intend for the IRS to become a national regulator of the charitable sector.").

[12] *New 1023-EZ Form Makes Applying for 501(c)(3) Tax-Exempt Status Easier; Most Charities Qualify IR-2014-77*, IRS (July 1, 2014), www.irs.gov/uac/Newsroom/New-1023-EZ-Form-MakesApplying-for-501c3Tax-Exempt-Status-Easier-Most-Charities-Qualify [hereinafter IRS Press Release].

[13] U.S. DEP'T OF TREASURY, INTERNAL REVENUE SERV., OMB NO. 1545-0056, FORM 1023-EZ: STREAMLINED APPLICATION FOR RECOGNITION OF EXEMPTION UNDER SECTION 501(C)(3) OF THE INTERNAL REVENUE CODE (2014), www.irs.gov/pub/irspdf/f1023ez.pdf [https://perma.cc/A2GN-DVDF] [hereinafter Form 1023-EZ].

[14] 1 NAT'L TAXPAYER ADVOCATE, 2015 ANNUAL REPORT TO CONGRESS 39 (2015) [hereinafter 2015 Taxpayer Advocate Report] ("By 2012, the volume of [the IRS's] open inventory was 36,034 cases, applications requiring little or no development were taking four months to close, and applications requiring assignment to a reviewer were taking nine months just to be assigned.").

[15] *See* 2015 Taxpayer Advocate Report, *supra* note 14 at 3 (noting that the Streamlined Application, in conjunction with other regulatory failures, "result[s] in a disturbing lack of information" about the tax-exempt entities and "undermin[es] the public's and the IRS's ability to effectively monitor this segment of the exempt organization population."

[16] Patricia Cohen, *IR.S. Shortcut to Tax-Exempt Status is Under Fire*, THE NEW YORK TIMES, April 8, 2015.

[17] Eric Franklin Amarante, *Unregulated Charity*, 94 WASH. LAW R. 1503 (2019).

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resulting in thousands of unworthy entities enjoying charitable status. If this widespread noncompliance continues unabated, it will decimate the public's confidence in the entire charitable sector.

Rather than place faith in the false hope of having a fully-funded IRS one day, this Article turns to other potential avenues solutions. More specifically, this Article highlights simple and cost-effective steps that individual states might implement to address the IRS's chronic failure to regulate charities. To identify these steps, I reviewed the formation documents of successful Streamlined Application filers in 2018 in the following five states: Florida, Idaho, Maryland, North Carolina, and Ohio. This study confirms the greatest fears of scholars[18] and commentators[19] who predicted that the Streamlined Application would result in widespread noncompliance.[20] I ultimately conclude that if the IRS were to have engaged in even the most cursory review of the applicant's organizational documents, it would have easily identified thousands of entities unworthy of tax-exempt status.[21] But beyond merely highlighting the problem, this study provides some lessons for states interested in stepping into the regulatory vacuum left by the IRS.[22] By studying the formation practices of states that produce Streamlined Application filers with high levels of regulatory compliance, this study identifies a number of low- or no-cost changes on the state level that address the IRS's failure to properly vet the formation documents of tax-exempt applications.[23]

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[18] Manoj Viswanathan, Essay, *Form 1023-EZ and the Streamlined Process for the Federal Income Tax Exemption: Is the IRS Slashing Red Tape or Opening Pandora's Box?*, 163 U. PA. L. REV. ONLINE 89 (2014–2015); George K. Yin, *The IRS's Misuse of Scarce EO Compliance Resources*, 146 TAX NOTES 267, 268 (2015).

[19] *See* 2015 TAXPAYER ADVOCATE REPORT, *supra* note 14; Comments to the National Council of Nonprofits to Discussion Draft: The Taxpayers First Act, April 6, 2018 page 4 ("By any measure, the problems with the express-lane approach to tax exemption continue and, indeed, are increasing…. And the IRS' primary obligation of preventing ineligible organizations and perhaps bad actors from receiving and exploiting tax-exempt status for personal gain is being shirked with every application processed. [The Streamlined Application] should be withdrawn immediately.").

[20] Amarante, *supra* note **Error! Bookmark not defined.**.

[21] *Study of Taxpayers That Obtained Recognition as IRC § 501(c)(3) Organizations on the Basis of Form 1023-EZ*, TAS Research and Related Studies, Vol. 2, 14 https://taxpayeradvocate.irs.gov/Media/Default/Documents/2019-ARC/ARC19_Volume1_TRRS_04_StudyExtent.pdf [https://perma.cc/7A2U-JJXD] (in a similar study, the National Taxpayer Advocate noted that "it took the reviewers about three minutes on average to review an organization's articles and determine whether there were acceptable purpose and dissolution clauses. The longest it too to search for an review articles was 15 minutes (in four cases). In over 90 percent of the cases, it took five minutes or less.").

[22] *See infra* part III.

[23] *Id.*

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Part I of this Article discusses the IRS's failure to regulate the charitable sector. This part begins by explaining the first step many organizations undertake in their journey toward tax-exempt status: forming a nonprofit corporation at the state level.[24] This part then discusses the IRS's "Organizational Test," which requires certain provisions to be included in an applicant's formation documents before tax-exempt status is appropriate. Part I concludes with a discussion of the tax-exempt application process and how the Streamlined Application's poor design has resulted in widespread noncompliance. Part II discusses the harms of the Streamlined Application's failure, including the damage to the charitable sector's reputation and the vulnerability of Streamlined Application filers. Part III sets forth the results of the study, including a description of the study's methodology and a discussion of each state's success rate in fulfilling the Organizational Test. Part IV analyzes the results of the study to determine state-specific lessons and what more poorly-performing states might do to increase their compliance rate. Part V is a conclusion.

I. OUR FAILURE TO REGULATE CHARITIES

Perhaps we should start with a simple question: why do we exempt some organizations from paying taxes? Somewhat surprisingly, the answer is not settled.[25] Legal scholars have only recently begun to formulate with justifications for the tax-exemption of certain entities, producing a robust and spirited debate.[26] But unfortunately, each theory fails to provide a

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[24] Alicia Alvarez & Paul R. Tremblay, INTRODUCTION TO TRANSACTIONAL LAWYERING PRACTICE (2013) at 363 ("In our experience, most organizations that opt to seek tax-exempt status from the IRS will want to start as a [nonprofit] corporation."). Incidentally, Alvarez and Tremblay's conclusion that most entities opt to form a nonprofit corporation is borne out by the study data, as the vast majority of entities that filed a Streamlined Application formed a nonprofit corporation.

[25] Mark A. Hall & John D. Colombo, *The Donative Theory of the Charitable Tax Exemption*, 52 OHIO STATE LAW JOURNAL 1379, 1381 ("It is extraordinary that no generally accepted rational exists for the multi-billion dollar exemption from income and property taxes that is universally conferred on 'charitable' institutions.").

[26] The traditional theory of tax-exemption posits that we should promote charitable activity through tax-exemption because charities lighten the burden of the government. *See* H.R.Rep. No 75- 1860, at 19 (3d Sess. 1938) ("The exemption from taxation …is based upon the theory that the Government is compensated for the loss of revenue by its relief from financial burden which would otherwise have to be met by appropriations from public funds."). Other leading theories justify tax-exemption due to market failures (*See* Henry Hansmann, *The Rationale for Exempting Nonprofit Organizations from Corporate Income Taxation*, 91 YALE L. J. 54 (1981)), the amount of risk assumed by nonprofit organizations (See Nina Crimm, *An Explanation of the Federal Income Tax Exemption for Charitable Organizations: A Theory of Risk Compensation*, 50 FLORIDA L. REV. 419), the governmental interest in promoting altruism (Rob Atkinson, *Altruism in Nonprofit Organizations*, 31 B.C. L. REV. 501 (1990)), and an argument that tax-exemption should turn on the level of donations a charity receives

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universally-accepted justification for the tax-exemption of charities.[27] This failure might not be surprising if one considers the absurd complexity of charity law, born from a persistent carelessness that has characterized the American tax-exempt regime since its inception.[28] The charitable regime reflects blindly-adopted law from as early as the 14th century[29] and a panoply of unprincipled Congressional acts.[30] Collectively, this has led to the facially-absurd notion that the same vague statute purports to govern the tax exemption of entities as disparate as churches, amateur bowling leagues, hospitals, and universities.

Complicating matters, the process for obtaining tax-exempt status has evolved in a manner driven more by administrative necessity than any coherent theoretical foundation.[31] But before delving into the application process in detail, it is important to discuss what most aspiring charities must do prior to applying for tax-exempt exemption: file as a legal entity with a state.[32]

A. The First Step: Formation

Although an entity does not have to be a nonprofit corporation in order to obtain tax-exempt status,[33] most charities are formed as nonprofit

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(Mark A. Hall & John D. Colombo, *The Donative Theory of the Charitable Tax Exemption*, 52 OHIO ST. L.J. 1379 (1991); Mark A. Hall & John D. Colombo, *The Charitable Status of Nonprofit Hospitals: Toward a Donative Theory of Tax Exemption*, 66 WASH L. REV. 307 (1991)).

[27] *See* Crimm, *supra* note 26 ("[I]t may appear remarkable that there is no universally-accepted theory to explain the fundamental reason underlying the deliberate and continued conferral of [the tax] exemption on all qualifying charitable organizations."); see also Rob Atkinson, *Altruism in Nonprofit Organizations*, 31 B.C. L. REV. 501 (1990). Professor Atkinson suggests that "If … we want a theory that takes account of the 'charity' of charities…, we are bound to be disappointed. At best, we will find a proxy for what we are inclined to believe is the real criterion. Alternatively, if we admit charity to be a complex phenomenon, we avoid the fallacy of the one true way, but only at the price of a seriously complicated legal definition. … [W]e can be sure from the outset that a legal definition of charity will not be entirely satisfactory, in large part because some of the things we want in an exemption theory are at odds with others."

[28] *See* Crimm, *supra* note 26 at 425.

[29] *Id.* ("The seeds of the tax exemption notion for American 'charitable' organizations can be traced to fourteenth century England.").

[30] *See, e.g.,* Robert M. Penna, *The Johnson Amendment: Fact-checking the Narrative*, STANFORD SOCIAL INNOVATION REVIEW, August 24, 2018, https://ssir.org/articles/entry/the_johnson_amendment_fact_checking_the_narrative (discussing the origins of the Johnson Amendment).

[31] *See* Amarante, *supra* note 17.

[32] *See* Alavarez, *supra* note 24.

[33] I.R.C. § 501(c)(3) refers to "[c]orporations, and any community chest, fund, or foundation" as the entities that may apply for tax-exempt status. See, however, the *Instructions for Form*

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corporations.[34] State law will dictate the rules for formation and governance of nonprofit corporations, but all states require incorporators to file a document to form a nonprofit corporation.[35] Depending on the state, this document might be known as either the charter,[36] the certificate of incorporation[37] or articles of incorporation.[38] Given that state law dictates nonprofit corporation formation, there are as many as 50 different variations in the formation process. Luckily, the process is relatively simple[39] and there are enough similarities across the states that one can safely assume that the formation process will involve filing a document containing something along the lines of the following information: the name of the organization, the organization's mission statement, the name and address of the organization's incorporator and registered agent, and whether the organization will have members.[40] Some states also require a fiscal year end date and the names and addresses of the initial officers and board of directors.[41] More often than not, this is the only information an incorporator will need to form an entity with a state.[42] However, if the founders of the nonprofit corporation desire to obtain tax-exempt status, the charter must also include specific language required by the IRS.[43] These required provisions, sometimes referred to as "magic" language, ensure that the nonprofit corporation is formed in a manner that avoids enriching individuals; prohibits the distribution of propaganda or intervention in campaign activity; and permanently dedicates its assets, even

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1023, *available at* https://www.irs.gov/pub/irs-pdf/i1023.pdf [https://perma.cc/M2FF-BGLB] ("Only certain corporations, unincorporated associations, and trusts are eligible for tax-exempt status under section 501(c)(3). Sole proprietorships, partnerships, and loosely affiliated groups of individuals are not eligible."

[34] *See* Alavarez, *supra* note 24.

[35] *See* Instructions for Form 1023, *available at* https://www.irs.gov/pub/irs-pdf/i1023.pdf [https://perma.cc/M2FF-BGLB] ("A corporation must be incorporated under the non-profit or non-stock laws of the jurisdiction in which it incorporates."); see also Alvarez, *supra* note 34 at 365 ("State law will control the type of entity used or created (corporation, trust, or unincorporated association) and the requirements of that entity.").

[36] *See, e.g.,* Tennessee Code § 48-52-102.

[37] *See, e.g.,* New York Not-For-Profit Corporation Law § 402.

[38] *See, e.g.,* California Code of Corporations § 5130. For this Article, the formation document will be referred to as the charter.

[39] Alvarez, *supra* note 34 at 366 ("The process is fairly simply, perhaps simpler than it should be, because filing the articles of incorporation may not necessarily require that someone have considered all the provisions of the state's nonprofit corporation act.").

[40] *See, e.g.,* Tennessee Code § 48-52-102.

[41] *Id*.

[42] *See infra*, Part III.B.

[43] *See Organizational Test – Internal Revenue Code Section 501(c)(3)*, IRS, www.irs.gov/charities-non-profits/charitable-organizations/organizational-test-internal-revenuecode-section-501c3 [http://perma.cc/66FN-VAT3].

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upon dissolution, to a charitable purpose.[44] This language is collectively known as the "Organizational Test."[45]

1. The Organizational Test

The Organizational Test is one of the core requirements an entity must meet in order to obtain tax-exempt status.[46] Though some commentators refer to the Organizational Test as little more than a formality,[47] others note that it contains, "in essence, the federal tax definition of charity."[48] Regardless of how it is viewed, the Organizational Test remains an important way for the IRS to help charities ensure future compliance with charity law.

a. The Nondistribution Constraint

Before delving into the Organizational Test in detail, there is some value in spending some time on the test's underlying goals. To that end, it is important to note that the term "nonprofit," when referring to charities, is a bit of a misnomer.[49] There is, in fact, no restriction on charities making a profit.[50] Indeed, if a charity consistently failed to realize profits, it would likely result

[44] Alvarez, *supra* note 34 at 366-67 describing the "magic" language as ensuring "that no part of the net earnings of the organization will inure to the benefit of a private shareholder or individual, no substantial part of the activities will be carrying on propaganda or otherwise attempting to influence legislation and that the organization will not participate or intervene in any political campaign on behalf of or in opposition to any candidate for public office."

[45] *See Organizational Test*, supra note 43; *see also* Terri Lynn Helge, *Rejecting Charity: Why the IRS Denies Tax Exemption to 501(C)(3) Applicants*, 14 PITTSBURGH TAX REVIEW, 1, 5 (2016) ("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.").

[46] *See Organizational Test*, supra note 43 ("In short, "[t]he organizing documents must limit the organization's purposes to exempt purposes in section 501(c)(3) and must not expressly empower it to engage, other than as an insubstantial part of its activities, in activities that are not in furtherance of one or more of those purposes.").

[47] David Flynn & Noel Fleming, *Private Foundation or Public Charity? Type III Supporting Organizations After the PPA*, 108 J. Tax'n 365, 366 (2008).

[48] Marion Fremont-Smith, *The Legal Meaning of Charity*, The Urban Institute, 2 (2013) available at https://www.urban.org/sites/default/files/the-legal-meaning-of-charity.pdf [https://perma.cc/JVQ7-8EZU].

[49] Bruce R. Hopkins, STARTING AND MANAGING A NONPROFIT ORGANIZATION, 7 (7th Ed. 2017)("The English language does not serve us well in this context, in that the term *nonprofit organization* is often misunderstood. This term does not refer to an organization that is prohibited by law from earning a *profit* (that is, an excess of gross earnings over expenses); *nonprofit* does not mean *no profit*.").

[50] Henry Hansmann, *The Role of Nonprofit Enterprise*, 89 YALE L. J. 837, 835 (1980) ("[A] nonprofit organization is not barred from earning a profit. Many nonprofits in fact consistently show an annual accounting surplus.").

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in a failure. Profits are how charities pay for their charitable works, and they are how Goodwill Industries pays rent to keep its stores open,[51] the American Lung Association conducts research on lung disease,[52] and Habitat for Humanity purchases building materials.[53]

Thankfully, the tax-exempt legal regime does not prohibit charities from making a profit.[54] Rather, the provisions required by the Organizational Test restrict how charities may *spend* those profits. In a nutshell (and in perhaps a gross overgeneralization), the provisions required by the Organizational Test prohibit charities from distributing profits to individuals. This restriction is known as the "Nondistribution Constraint" and is considered the defining characteristic of all charities.[55] Divined from the statutory provision that prohibits private inurement,[56] the Nondistribution Constraint requires that a nonprofit's "[n]et earnings, if any, must be retained and devoted in their entirety to financing further production of the services that the organization was formed to provide."[57] In this manner, the Nondistribution Constraint promotes charitable activity and limits noncharitable activity.[58] Under the reign of the Nondistribution Constraint, no matter how much an organization may have in reserves, it may not distribute funds to individuals. As such, the Nondistribution Constraint limits the ability of individuals involved with the organization to enrich themselves at the expense of the organization's charitable purpose.[59]

The contours of the Nondistribution Constraint are established and defined by the provisions that make up the Organizational Test. These provisions are

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[51] *About Us*, GOODWILL, https://www.goodwill.org/about-us/ [perma.cc/JQ2V-3UZP]

[52] AMERICAN LUNG ASSOCIATION, https://www.lung.org.

[53] HABITAT FOR HUMANITY, https://habitat.org.

[54] Hansmann, *supra* note 50.

[55] *Id*. at 838.

[56] Reg. 1.501(c)(3)-1(c)(2) ("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 individuals.").

[57] Hansmann, *supra* note 50 at 838.

[58] Alvarez, *supra* note 34 at 363 ("One might argue that the non-distribution constraint provides some assurance that the subsidy to the nonprofit organization will ultimately benefit the consumers of the organization [i.e., the beneficiaries of charity] in lower prices or higher quality.").

[59] Although the IRS requires all charities to include provisions that operationalize the nondistribution constraint in their formation documents, there is little policing of the restriction. The responsibility of compliance falls largely upon overworked and uninterested state attorneys general. Hansmann, *supra* note 50 at 873-74. ("[M]ost states … make little or no effort to enforce [the nondistribution constraint]. As a rule, its enforcement is placed exclusively in the hands of the state's attorney general…. Yet in most states neither the office of the attorney general nor any other office of the state government devotes any appreciable amount of resources to the oversight of nonprofit firms.").

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discussed in detail in the following sections, but, in short, the Organizational Test might be most easily understood as serving two distinct purposes: first, limiting the activities of the organization to charitable purposes; and second, ensuring that all organizational assets are permanently dedicated to charity.

b. The Limitation of Activities Clause

The first purpose of the Organizational Test is limiting the activities of charities to those that are in furtherance of a charitable purpose.[60] In the words of the statute, "in order to be exempt as an organization described in section 501(c)(3), an organization must be both organized … exclusively for one or more [charitable] purposes."[61] The statute has been interpreted to conceive of this limitation in two ways: first, the organization's charter must "limit the purposes of such organization to one or more exempt purposes;" and second, the charter must "not expressly empower the organization to engage, otherwise than as an insubstantial part of its activities, in activities which in themselves are not in furtherance of one or more exempt purposes" (the "Limitation of Activities Clause").[62] Importantly for this Article, the IRS expressly requires a Limitation of Activities Clause in the charity's charter.[63] Neither statements of officers evidencing intent to limit activities nor limitations contained in the organization's bylaws are sufficient.[64] Indeed, even if an applicant can prove that its actual operations have been exclusively charitable, the IRS should not award tax-exempt status unless the Limitation of Activities Clause appears in the organization's charter.[65]

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[60] I.R.C. § 1-501(c)(3)-1(a)(1).

[61] *Id.*

[62] Treas. Reg. § 1-501(c)(3)-1(b)(1)(i)(A)-(B).

[63] *Tax Exempt Status for Your Organization*, Publication 557, IRS at 25, *available at* https://www.irs.gov/pub/irs-pdf/p557.pdf [hereinafter Publication 557] ("The requirement that your organization's purposes and powers must be limited by the articles of organization isn't satisfied if the limit is contained only in the bylaws or other rules or regulations. Moreover, the organizational test isn't satisfied by statements of your organization's officers that you intend to operate only for exempt purposes.").

[64] *Id.* at 25 ("The requirement that your organization's purposes and powers must be limited by the articles of organization isn't satisfied if the limit is contained only in the bylaws or other rules or regulations. Moreover, the organizational test isn't satisfied by statements of your organization's officers that you intend to operate only for exempt purposes.").

[65] Treas. Reg. § 1.501(c)(3)-1(b)(1)(i-iv) ("In no case shall an organization be considered to be organized exclusively for one or more exempt purposes, if, by the terms of its articles, the purposes for which such organization is created are broader than the purposes specified in section 501(c)(3). The fact that the actual operations of such an organization have been exclusively in furtherance of one or more exempt purposes shall not be sufficient to permit the organization to meet the organizational test. Similarly, such an organization will not meet the organizational test as a result of statements or other evidence that the members thereof intend to operate only in furtherance of one or more exempt purposes.")

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This may appear to be the IRS valuing form over substance, but there are good reasons to require the Limitation of Activities Clause to be in an organization's charter. First, most organizations are formed without an explicit expiration date, with many charities lasting for generations.[66] Given how long a charity might survive, the intent of the individuals who formed the entity is irrelevant. Although a particular board of directors may admirably limit an organization's activities to charitable purposes, there is no guarantee that any future boards will do the same. Thus, it is important to govern the behavior of future boards of directors by limiting the permissible activities of the organization in the charter, a document that will govern the organization's activities for its lifetime. Second, many charities are largely self-policed. Although state attorneys general and the IRS have the authority to bring actions against charities,[67] any malfeasance by a charity is more likely to be identified and remedied by an insider.[68] Directors and members of nonprofit organizations have the power to being derivative suits to enforce, for example, the Nondistribution Constraint.[69] And because the governing mechanisms of an organization are, largely, set forth in internal documents, it makes intuitive sense to include important limitations in a charity's charter document.

The actual language of Limitation of Activities Clauses found in charters is relatively uniform. This is because the IRS has published sample language that complies with the Organizational Test, and most organizations simply include the suggested language in their charter documents.[70] The language is

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[66] *See, e.g.,* The Ford Foundation, https://www.fordfoundation.org/about/about-ford/our-origins/ [https://perma.cc/B4DY-YKR4] ("In 1936, Edsel Ford—son of Henry, the founder of the Ford Motor Company—established the Ford Foundation with an initial gift of $25,000.").

[67] Hansmann, *supra* note 50 at 873-74. ("[M]ost states … make little or no effort to enforce [the nondistribution constraint]. As a rule, its enforcement is placed exclusively in the hands of the state's attorney general…. Yet in most states neither the office of the attorney general nor any other office of the state government devotes any appreciable amount of resources to the oversight of nonprofit firms.").

[68] *Id*. at 875. Professor Hansmann points out that the compliance is self-imposed by the sector, suggesting that "social norms that reinforce legal restraints on profiteering" are enforcing the nondistribution constraint in the presence of "minimal policing."

[69] *See* Marion Fremont-Smith, GOVERNING NONPROFIT ORGANIZATIONS: FEDERAL AND STATE LAW AND REGULATION 334 (2004); *see also* Deborah A. DeMott, SHAREHOLDER DERIVATIVE ACTIONS: LAW AND PRACTICE § 2.12 (2003). On rare occasions, courts will give standing to private individuals. Terri Lynn Hedge, *Policing the Good Guys: Regulation of the Charitable Section through a Federal Charity Oversight Board*, 19 CORNELL J. L. & PUB. POL'Y 1, 41 (2008) (noting that "some courts have granted standing to private individuals to bring suit against charitable organizations under the special interest doctrine.").

[70] Publication 557, supra note 63 at 70.

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comprised of three sentences, and it might be best understood by considering each sentence separately. The first sentence is as follows:

> No part of the net earnings of the corporation shall inure to the benefit of, or be distributable to its members, trustees, officers, or other private persons, except that the corporation shall be authorized and empowered to pay reasonable compensation for services rendered and to make payments and distributions in furtherance of the [corporation's charitable] purposes.[71]

This sentence ensures that charities may not, other than in the form of reasonable salaries, distribute funds to individuals. This prohibition is known as the prohibition against private inurement (for insiders such as directors and officers) and private benefit (for non-insiders).[72] This sentence directly addresses the core concern of the Nondistribution Constraint, by prohibiting distributions to individuals and encouraging distributions toward the entity's charitable purpose.[73]

The second sentence of the Limitation of Activities Clause shifts the focus from distributions to individuals and emphasizes political activity. It reads as follows:

> No substantial part of the activities of the corporation shall be the carrying on of propaganda, or otherwise attempting to influence legislation, and the corporation shall not participate in, or intervene in (including the publishing or distribution of statements) any political campaign on behalf of or in opposition to any candidate for public office.

This sentence ensures that the activities of the organization avoid impermissible political activity or excessive involvement in lobbying.[74] Unlike the first sentence, which focuses on prohibiting individual enrichment, this sentence endeavors to keep the organization focused on its stated charitable purpose rather than political or lobbying activities.

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[71] *Id.* The third article in the sample formation document is as follows: "Said corporation is organized exclusively for charitable, religious, educational, and scientific purposes, including, for such purposes, the making of distributions to organizations that qualify as exempt organizations under section 501(c)(3) of the Internal Revenue Code, or the corresponding section of any future federal tax code."

[72] *Overview of Inurement/Private Benefit Issues in IRC 501(C)(3)*, IRS, https://www.irs.gov/pub/irs-tege/eotopicc90.pdf.

[73] See *supra* notes 49-59.

[74] The prohibition against political activity is more commonly known as the Johnson Amendment. For a detailed discussion of the prohibition against political activity, *see* Penna, *supra* note 30.

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The Limitation of Activities Clause ends with the following sentence, which serves as a sort of catchall provision to prohibit the charity from engaging in any activities that run contrary to the statute:

> Notwithstanding any other provision of these articles, the corporation shall not carry on any other activities not permitted to be carried on (a) by a corporation exempt from federal income tax under section 501(c)(3) of the Internal Revenue Code, or the corresponding section of any future federal tax code, or (b) by a corporation, contributions to which are deductible under section 170(c)(2) of the Internal Revenue Code, or the corresponding section of any future federal tax code.[75]

This sentence serves as a sort of "belt and suspenders" approach to ensure all activities by the organization are permissibly charitable, and, when combined with the first two sentences, the Limitation of Activities Clause provides a rough guide to charities on how to operate in a manner that complies with IRS regulations. These sentences specifically prohibit both individual enrichment and political activity, and the third sentence generally prohibits against any activity that would otherwise violate IRS regulations.

c. The Dissolution Clause

In addition to the Limitation of Activities Clause, the Organizational Test requires charities to restrict the distribution of assets upon dissolution of the organization. While the Limitation of Activities Clause focuses on the activities of the charity (restricting distributions to insiders, substantial lobbying, and political activity), the Dissolution Clause regulates how assets are distributed once the entity ends operations. Similar to the first sentence of the Limitation of Activities Clause, the Dissolution Clause supports the Nondistribution Constraint. In conjunction, the two clauses ensure that assets of a charity are never misused, either while the organization is operating or when the organization ceases to operate. After all, what good would the restrictions of the first sentence of the Limitation of Activities Clause serve (i.e., restricting the enrichment of individuals) if an organization were permitted to hoard assets, decide to dissolve, and distribute assets to insiders upon dissolution? To address this concern, the Dissolution Clause ensures "assets of an organization" are "permanently dedicated to an exempt purpose."[76] More specifically, the Dissolution Clause requires charities that are dissolving to distribute the remaining assets in one of the following manners: (i) in furtherance of the organization's charitable purpose, (ii) to

[75] Publication 557, *supra* note 63.
[76] Publication 557 at 25, *available at* https://www.irs.gov/pub/irs-pdf/p557.pdf.

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another 501(c)(3) organization; (iii) to the federal government, or (iv) to a state or local government.[77]

Similar to the Limitation of Activities Clause, the IRS has published suggested language that appears in the formation documents of many charities that enjoy charitable status. The suggested language is as follows:

> Upon the dissolution of the corporation, assets shall be distributed for one or more exempt purposes within the meaning of section 501(c)(3) of the Internal Revenue Code, or the corresponding section of any future federal tax code, or shall be distributed to the federal government, or to a state or local government, for a public purpose. Any such assets not so disposed of shall be disposed of by a Court of Competent Jurisdiction of the county in which the principal office of the corporation is then located, exclusively for such purposes or to such organization or organizations, as said Court shall determine, which are organized and operated exclusively for such purposes.[78]

Simply put, while the Limitation of Activities Clause ensures that entities will adhere to appropriate restrictions on distribution while the organization is active, the Dissolution Clause ensures that assets are appropriately handled when the organization ends. Together, the Limitation of Activities Clause and the Dissolution Clause make up the Organizational Test, arguably the most fundamental of requirements for organizations that aspire to be charities.[79]

B. The Second Step: Applying for Tax-Exempt Status

Once formation is complete, the nonprofit corporation must draft and adopt bylaws[80] and obtain an employer identification number.[81] At that point, the

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[77] *See* Appendix. Sample Articles of Organization, Publication 557, *supra* note 63 at 70.
[78] *Id.*
[79] Teri Helge, *Rejecting Charity: Why the IRS Denies Tax Exemption to 501(C)(3) Applicants*, 14 PITTSBURGH TAX REVIEW, 1, 5 (2016) ("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.").
[80] Although the Streamlined Application does not explicitly require bylaws, most state nonprofit corporation statutes require bylaws. See, e.g., Tenn. Code §48-52-106(a) ("The incorporators or board of directors of a corporation shall adopt initial bylaws for the corporation.").
[81] See Form 1023-EZ, supra note 13, line 2.

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entity is eligible to apply to the IRS for tax-exempt status.[82] Until relatively recently, that meant filing the Form 1023.[83] Before its recent conversion to an online form,[84] the IRS estimated that this behemoth of an application would take approximately 105 hours to complete.[85] All told, with required attachments and exhibits, a completed Form 1023 could boast as many as 100 pages.[86] But the tax-exempt application process was fundamentally altered with the introduction of the Streamlined Application, a "radical change to a decades old process."[87] If one were to combine the sheer bulk of such tax-exempt applications with increasingly severe budget cuts,[88] it is little wonder that the IRS was unable to process applications in a timely manner.[89]

1. The Streamlined Application

In comparison to the Form 1023, the Streamlined Application represented a dramatically less intense mechanism for obtaining tax-exempt status. To be eligible for the Streamlined Application, an applicant must answer "no" to each of the questions on the Form 1023-EZ Eligibility Worksheet.[90] Among other questions, the Form 1023-EZ Eligibility Worksheet asks applicants if they have less than $250,000 in assets and must reasonably anticipate less

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[82] Not all organizations are required to submit tax-exempt applications. More specifically, churches and very small organizations (those that expect less than $5,000 in annual gross receipts) are automatically tax-exempt. *See Organizations Not Required to File Form 1023*, *available at* www.irs.gov/charities-non-profits/charitable-organizations/organizations-not-required-to-file-form-1023 [https://perma.cc/2JG7-E9GE].

[83] U.S. DEP'T OF TREASURY, INTERNAL REVENUE SERV., OMB NO. 1545-0056, FORM 1023: APPLICATION FOR RECOGNITION OF EXEMPTION UNDER SECTION 501(C)(3) OF THE INTERNAL REVENUE CODE (2017) [hereinafter Form 1023], https://www.irs.gov/pub/irs-pdf/f1023.pdf [https://perma.cc/2SQV-5BGU].

[84] *IRS Revises Form 1023 for Applying for Tax-Exempt Status*, IRS, January 31, 2020, https://www.irs.gov/newsroom/irs-revises-form-1023-for-applying-for-tax-exempt-status [https://perma.cc/6X8G-R9SW].

[85] *See* Instructions for Form 1023, *available at* https://www.irs.gov/pub/irs-pdf/i1023.pdf [https://perma.cc/M2FF-BGLB]. This includes 9 hours and 39 minutes to prepare the form, 89 hours and 26 minutes of recordkeeping, and 5 hours and 10 minutes to learn about the law.

[86] See How Long Does It Take to Complete Form 1023, FOUND. GROUP, www.501c3.org/frequently-asked-questions/how-long-does-it-take-to-complete-form-1023/ [http://perma.cc/TTR3-YRAQ].

[87] Viswanathan *supra* note 18 at 89.

[88] Joe Davidson, *IRS Chief Departs, Blasting Congress for Budget Cuts Threatening Tax Agency*, WASH. POST (Nov. 7, 2017), https://www.washingtonpost.com/news/powerpost/wp/2017/11/07/irschief-departs-blasting-congress-for-budget-cuts-threatening-tax-agency/.

[89] See Yin, *supra* note 18.

[90] *See Instructions to the Form 1023-EZ*, available at https://www.irs.gov/pub/irs-pdf/i1023ez.pdf, at 13-20 [https://perma.cc/5UJ7-546W] [hereinafter Form 1023-EZ Instructions].

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than $50,000 in annual gross receipts in any other next three years.[91] In this manner, the Streamlined Application is restricted to smaller organizations. Or more specifically, it was designed for those organizations that "reasonably anticipate" being smaller.[92]

In stark contrast to the estimated 105 hours it takes to complete the Form 1023's 26 pages,[93] the Streamlined Application is two-and-a-half-pages long and the IRS estimates applicants will spend about 19 hours learning about the law and completing the Streamlined Application.[94] A difference of 86 hours—over two full work weeks—is certainly significant, but in practice, the Streamlined Application demands far less than 19 hours of work.[95] As the National Council of Nonprofits argued, completion of the Streamlined Application could take "as little as an hour or so—not because [applicants] deliberately intend to skirt the law, but because [applicants] simply don't know or understand what they are required to certify."[96]

Given the difference in length, it should not be surprising that the Streamlined Application elicits far less information than the Form 1023. By way of example, the Form 1023 requires disclosure of the salaries for the five highest paid insiders, employees, and independent contractors.[97] In contrast, the Streamlined Form asks whether the organization plans to compensate insiders, only allowing applicants to respond with a "yes" or "no."[98] The Form 1023 requires applicants to draft a narrative description of "past, present, and planned activities," which includes a full description of "all of the activities in which it expects to engage, including standards, criteria, procedures, or other means adopted or planned for carrying out the [charitable] activities."[99] The Streamlined Application requires no such

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[91] *See* Form 1023-EZ Instructions, supra note 90 at 13 (noting that an entity is not eligible to use the Streamlined Application if (i) it anticipated "annual gross receipts will exceed $50,000 in any of the next 3 years," (ii) its "annual gross receipts exceeded $50,000 in any of the past 3 years," or (iii) it has "assets the fair market value of which is in excess of $250,000.").

[92] *Id.*

[93] *See* Instructions for Form 1023, *supra* note 85.

[94] *See* Form 1023-EZ Instructions, *supra* note 90 at 10.

[95] See Yin, *supra* note note 18.

[96] Letter from Tim Delaney, Nat'l Council of Nonprofits to the Office of Info. and Regulatory Affairs 3 (Apr. 30, 2014), www.ctphilanthropy.org/sites/default/files/resources/National%20Council%20of%20Nonprofits%20Comments%20About%20IRS%20Proposed%20Form%201023-EZ.pdf [https://perma.cc/6MBL-VGML].

[97] Form 1023, *supra* note 83.

[98] *See* Form 1023-EZ, supra note 13, at 2, pt. III, 1. 5 ("Do you or will you pay compensation to any of your officers, directors, or trustees?").

[99] *See* BRUCE R. HOPKINS, THE LAW OF TAX-EXEMPT ORGANIZATIONS 798 (11th ed. 2015).

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narrative, and does not elicit any information about the applicant's planned charitable activities beyond a request for the organization's mission statement.[100] Further, unlike the Form 1023, the Streamlined Application does not ask the applicant for any financial information,[101] disclosure of related parties and potential conflicts of interest,[102] or identification and explanation of close connections with other organizations.[103] Finally, and perhaps of most interest to this Article, the Form 1023 requires each applicant organization to provide copies of its charter and bylaws,[104] and asks applicants to "state specifically" which provision in the formation documents restricts the organization to exempt purposes[105] and which provision ensures assets are dedicated to charitable purposes upon the organization's dissolution.[106] In other words, the Form 1023 requires applicants to not only identify which charter provisions meet the Organizational Test, but also to provide a copy of the organization's actual charter. In sharp contrast, the Streamlined Application merely asks the applicant to attest that it meets the Organizational Test.[107]

2. Criticisms of the Streamlined Application

From the perspective of efficiency, the Streamlined Application was a clear success: the IRS eliminated the backlog of tax-exempt applications and now promises to process tax-exempt applications within 90 or 180 days.[108] Unfortunately, this efficiency came at a price. Under the assumption that smaller organizations require less scrutiny, the IRS crafted an application

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[100] *See* Form 1023-EZ, supra note 13.

[101] *See* Form 1023, *supra* note 83, at 9-10, Pt. IX. The Form 1023 requires "actual or projected financial information (*e.g*., budgets) for three to five years" and "a balance sheet for the organization's most recently completed tax year." See *Form 1023: Required Financial Information*, https://www.irs.gov/charities-non-profits/form-1023-required-financial-information [https://perma.cc/9GU4-WTCU]

[102] Form 1023, *supra* note 83, at 2-3, Pt. V.

[103] Form 1023, *supra* note 83, at 5-7, Pt. VIII, 1. 15.

[104] Form 1023, *supra* note 83.

[105] Form 1023, *supra* note 83, Part III 1 ("Section 501(c)(3) requires that your organizing document limit your purposes to one or more exempt purposes within section 501(c)(3), such as charitable, religious, educational, and/or scientific purposes. … State specifically where your organizing document meets this requirement.").

[106] Form 1023, *supra* note 83, Part III 2 ("Section 501(c)(3) requires that your organizing document provide that upon dissolution, your remaining assets be used exclusively for section 501(c) (3) exempt purposes, such as charitable, religious, educational, and/or scientific purposes. … State specifically where your organizing document meets this requirement.").

[107] *See* Form 1023-EZ, supra note 13, Part II, 5-7.

[108] *Where's My Exemption Application?*, IRS, www.irs.gov/charities-non-profits/charitableorganizations/wheres-my-application [http://perma.cc/67BM-PEVB].

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process that is utterly devoid of rigor.[109] In fact, many commentators argue that the IRS has decided to virtually ignore the applications of smaller organizations.[110]

Initially, the IRS ignored these complaints and stubbornly supported the Streamlined Application. Its primary argument was that any complaints about the Streamlined Application ignored the fact that it was intended for organizations such as "a small soccer or gardening club" as opposed to "a major research organization."[111] The implication, a debatable one, is that smaller organizations present less risk to the public and therefore deserve less scrutiny.[112] Further, with an apparent confidence in the Streamlined Application's ability to vet aspiring charities, the IRS published tax-exempt entities that utilized the Streamlined Application on the same list as entities that used the Form 1023.[113] Thus, one could not easily tell the difference between an entity that filed a Form 1023 or an entity that filed a Streamlined Application without directly asking the charities or requesting the documents from the IRS (a relatively long process).[114] More recently, however, the IRS

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[109] Patricia Cohen, *IR.S. Shortcut to Tax-Exempt Status is Under Fire*, THE NEW YORK TIMES, April 8, 2015.

[110] *See generally*, Amarante, *supra* note 17. See also 1 NAT'L TAXPAYER ADVOCATE, 2015 ANNUAL REPORT TO CONGRESS 39 (2015) [hereinafter 2015 TAXPAYER ADVOCATE REPORT]. According to the National Taxpayer Advocate, an independent organization housed at the IRS dedicated to protecting the rights of taxpayers, the Streamlined Application makes it impossible for "the IRS … to effectively determine whether applicants qualify as [charitable] organizations." *See* Yin, *supra* note 18 (calling the Streamlined Application process "a sham"); Viswanathan, *supra* note 18; Letter from Tim Delaney, Nat'l Council of Nonprofits to the Office of Info. and Regulatory Affairs 3 (Apr. 30, 2014), https://www.ctphilanthropy.org/sites/default/files/resources/National%20Council%20of%20Nonprofits%20Comments%20About%20IRS%20Proposed%20Form%201023-EZ.pdf [https://perma.cc/X3WB-DZQ7]; Letter from Alissa H. Gardenswartz, President, Nat'l Ass'n of State Charity Officials, to Sunita Lough, Comm'r, Tax Exempt & Gov't Entities Div. (May 23, 2014), www.nasconet.org/wp-content/uploads/2018/03/May-23-letter-to-IRS-re-1023EZ.pdf [https://perma.cc/CBZ8-MWLR].

[111] *New 1023-EZ Form Makes Applying for 501(c)(3) Tax-Exempt Status Easier; Most Charities Qualify IR-2014-77*, IRS (July 1, 2014), www.irs.gov/uac/Newsroom/New-1023-EZ-Form-MakesApplying-for-501c3Tax-Exempt-Status-Easier-Most-Charities-Qualify [https://perma.cc/A2SE-LYZ5].

[112] For the counterargument, *see* Amarante, *supra* note 17; *see also* Yin, *supra* note 18 (noting that many large organizations were once small organizations).

[113] *Tax Exempt Organization Search*, IRS, https://apps.irs.gov/app/eos/.

[114] *IRS Makes Approved Form 1023-EZ Data Available Online*, IRS (Feb. 22, 2017), https://www.irs.gov/newsroom/irs-makes-approved-form-1023ez-data-available-online [https://perma.cc/8ZH2-RLAB] (noting that before the announcement, "Form 1023-EZ data was only available through a lengthier process that including completing and submitting Form 4506-A to the IRS").

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began to publish separate lists of Streamlined Application filers.[115] The point of this data, according to Commissioner Koskinen, was to "allow taxpayers to more easily research information on tax-exempt organizations."[116] This announcement carried a hint of an admission that some Streamlined Application critics had merit. After all, if the Streamlined Application were as rigorous as the Form 1023, there would be no need to indicate which form a particular entity filed. In fact, one might argue that the only reason to publish a separate list of Streamlined Application filers is because the process is less trustworthy.[117]

The separate publication of Streamlined Application filers is not the only example of the IRS admitting the possibility that unworthy applicants might obtain tax-exempt status through the Streamlined Application. As early as the Streamlined Application announcement, the IRS hinted that the Streamlined Application might result in unworthy entities obtaining charitable status by highlighting the IRS's ability to use freed-up resources to identify such unworthy charities.[118] To that end, Koskinen said

> Rather than using large amounts of IRS resources up front reviewing complex applications during a lengthy process, we believe the streamlined form will allow us to devote more compliance activity on the back end to ensure groups are actually doing the charitable work they apply to do.[119]

In other words, if any unworthy charities obtained status through the Streamlined Application, the IRS promised to identify such bad actors by reviewing their actual activities (as opposed to identifying such entities in the application phase). This argument boasts an intuitive appeal. After all, who cares what applicants hope to do if the IRS can instead learn what charities are actually doing? But however appealing, there are a number of problems with this approach. First, how, precisely, would the IRS identify which entities to scrutinize? Commentators have convincingly argued that the Streamlined Application elicits so little information that the IRS has no means of identifying the charities that deserve scrutiny.[120] As Professor Yin

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[115] *Id.* ("The data … is available in spreadsheet format and includes information for approved applications beginning in mid-2014, when the 1023-EZ form was introduced, through 2016. The information will be updated quarterly….").
[116] *Id.*
[117] *See generally*, Amarante, *supra* note 17.
[118] IRS PRESS RELEASE, July 1, 2014, *New 1023-EZ Form Makes Applying for 501(c)(3) Tax-Exempt Status Easier; Most Charities Qualify*, available at www.irs.gov/uac/Newsroom/New-1023-EZ-Form-Makes-Applying-for-501c3Tax-Exempt-Status-Easier-Most-Charities-Qualify [https://perma.cc/A2SE-LYZ5].
[119] *Id.*
[120] *See* Yin *supra* note 18.

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notes, “Because there is essentially no information obtained about applicants upfront, the IRS will be largely in the dark to determine which groups it should challenge at the back end.”[121] Second, and perhaps more alarmingly, the announcement of the Streamlined Application came shortly after the IRS decided to exempt most charities from meaningful annual reporting requirements. More specifically, any charity that claims that it normally receives less than $50,000 in gross receipts is permitted to file a truncated annual report known as the Form 990-N or “e-Postcard”.[122] Unlike the more traditional annual reports, the e-Postcard requires no disclosure of financial information (other an acknowledgment that it “normally receives less than $50,000 in gross receipts”), no information on salaries, and no requirement to describe any charitable activities performed.[123] Thus, without any meaningful annual reporting requirement, the IRS’s promise to focus on the “back end” is bound to fail. Without regularly collecting information about the activities of charities, the only option left to the IRS is random audits, which is a wildly inefficient mechanism for large-scale monitoring.[124]

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[121] Yin *supra* note 18 (arguing that the Streamlined Form “will enable the [IRS] to make a major inroad into its [tax-exempt application] backlog because it will not need to devote any significant resources to the processing of the new, short-form applications. Because the short form basically does not ask for any specific information from the applicant, there is really nothing for the IRS to do in processing it.”).

[122] *Annual Electronic Filing Requirement for Small Exempt Organizations – Form 990-N (e-Postcard)*, IRS, https://www.irs.gov/charities-non-profits/annual-electronic-filing-requirement-for-small-exempt-organizations-form-990-n-e-postcard [https://perma.cc/HE7K-KMH2].

[123] *Id.*; *see generally*, Amarante, *supra* note 17.

[124] *See* Yin *supra* note 18 (“Random selection is the gold standard for doing research. But undertaking truly random audits as an administrative tool is incredibly inefficient.”). *See also* Sasha Courville, Christine Parker & Helen Watchirs, *Introduction: Auditing in Regulatory Perspective*, 25 LAW & POL’Y 179, 180 (2003) (“An audit might promise to compensate for lack of government regulatory oversight and to provide accountability for organizational behavior. Yet the capacity of an audit to do so depends on the answers to a number of questions: Who are the auditors? What is their expertise? How are they regulated or accredited? What is their relationship to the auditee? What methods do the auditors use to collect data or evidence? How, if at all, do they sample the data to be checked? To what extent do they use fieldwork, rely on expert opinions, rely on checks of internal controls and systems? How widely do they consult and to what extent do they rely on consultations? How authentic is the participation of any stakeholders? How do the auditors form an opinion on the data or evidence? Who sets the parameters of the opinion that the auditor is to form? To what extent are the audit findings negotiated with the auditee before being published? What is the response of the auditees to the audit? Is it possible to measure the impact of the audit process? In what intended and/or unintended ways does the prospect or reality of audit change the behavior of the auditee? Is there evidence of ‘creative compliance’ to maintain autonomy while appearing to comply? Is there evidence of dysfunctional side-effects or conflicts between the consequences of audit and effectiveness or performance?”).

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Ultimately, the Streamlined Application and the e-Postcard combine to create a regulatory blind spot. In effect, the IRS has determined that any organization that anticipates less than $50,000 in gross receipts will not be vetted on the front-end (the application stage) and any organization that "normally receives less than $50,000 in gross receipts" will not be monitored on the back-end. This results in the IRS virtually ignoring a huge swath of the charitable sector.

II. THE HARMS OF UNREGULATED CHARITY

At this point, it might be a good idea to discuss why any of this matters. In other words, what, precisely, are the concrete harms of the IRS's failure to regulate and monitor smaller charities? If the harms are not cognizable, then this is merely an academic exercise and the IRS is completely justified in deciding to subject smaller charities to less (or, indeed, no) scrutiny. This section will discuss two distinct harms of the IRS's failure to regulate: (i) the negative effect on the reputation of the charitable sector as a whole, and (ii) the possibility that smaller charities formed in good faith will be vulnerable to loss of charitable status.[125]

A. *A Tarnished Halo – Loss of Public Faith in the Charitable Sector*

The success of an individual charity sector relies upon the reputation of the entire charitable sector. At first blush, this might appear to be an overstatement. After all, the tax code provides a strong incentivize for donors to give to charities with the promise of a reduced tax burden.[126] If this incentive is strong enough, the reputation of the charitable sector would be irrelevant, as donors would be inspired to financially support the sector simply out of selfishness. But this initial instinct is not supported by reality. In fact, many donors and volunteers give time and money to charities not to lower their tax burden, but because it feels good to dedicate donate to a good cause. This good feeling is known as the "warm glow."[127] As Professor Usha Rodrigues argues, the warm glow is "a specific kind of utility that comes from giving" to charities.[128] Rodrigues points out that many of the goods and services provided by charities can be acquired through for-profit entities, sometimes in a more convenient manner and oftentimes more cheaply.[129] For

[125] For an argument focusing on the IRS's failure to monitor smaller charities, as opposed to vet, *see* Amarante, *supra* note 17.

[126] I.R.C. § 170(b)(1)(vii).

[127] Brian Galle, *Keeping Charity Charitable*, 88 TEXAS LAW REVIEW 1213, 1222 (2010).

[128] Usha Rodrigues, *The Power of Warm Glow*, 88 TEXAS LAW REVIEW *SEE ALSO* 149, 151 (2010).

[129] *Id*. at 152 (discussing "a local nonprofit food cooperative is selling more than the free-range eggs or organic strawberries that Whole Foods and other for-profits market so effectively.")

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example, in most cities, it is easy to obtain organic vegetables from a grocery store chain.[130] Despite the abundance of organize produce in many cities, people continue to patronize nonprofit cooperative and farmers markets. This suggests that these entities offer more than just organic produce. Rather, according to Rodrigues, these entities offer "community participation" or perhaps the opportunity of "investment in local farms."[131] Whatever the reason, it is more than merely financial in nature. Rather, it is "a distinctive ethos that is incompatible with the profit motive and closely connected to the construction of an individual's social identity."[132]

Rodrigues suggests that the warm glow is so valuable that the tax incentives are unnecessary for charities rich in warm glow.[133] For proof, one need look no further than the financial sacrifice of many charity employees, who could secure more remunerative work in the for-profit sector. Therefore, one might reasonable conclude that any phenomenon that threatens the warm glow would affect the entire charitable sector. If the nonprofit cooperative in Rodrigues's hypothetical did not provide either the community participation or an opportunity to invest in local farms, one might assume that patrons would begin treating it as just another grocery store. And if a for-profit grocery store were to offer the same organic vegetables, it would appear to be a viable alternative.

It is reasonable to suspect that the IRS's failure to regulate the charitable sector will harm the sector's warm glow. As former Internal Revenue Commissioner Mark Everson has argued, a failure to address widespread noncompliance in the sector might result in "the loss of the faith and support that the public has always given to this sector."[134] Everson was speaking about abuses by charities, not the failure of the IRS to regulate charities, but the argument stands. If the public cannot trust the legitimacy of charities, it might lose faith in the charitable sector, and if that faith is eroded, the warm glow is at risk. Or as Professor Rossman more succinctly argues, "the chief function of the IRS as it relates to the charitable sector is to monitor who qualifies for 501(c)(3) status to assure the public and donors that the charitable subsidy is utilized for legitimate charitable purposes."[135]

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[130] *Id*.
[131] *Id*.
[132] *Id*. at 152-53.
[133] *Id*. at 153. (As Rodrigues argues, "[e]ven in a tax-neutral world, at least some nonprofits would continue to flourish because they offer a special kind of warm glow that for-profits cannot provide, the warm glow of participating in a nonprofit organization.")
[134] Albert B. Crenshaw, *Tax Abuse Rampant in Nonprofits, IRS Says*, WASH. POST, April 5, 2005
[135] Matthew Rossman, *Evaluating Trickle Down Charity*, 79 BROOKLYN L. R. 1455, 1500-01 (2014).

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B. Leaving Charities Vulnerable to Attack

Beyond the loss of the warm glow, the IRS's failure to recognize widespread compliance has another potential negative: leaving smaller charities vulnerable. If a sector is rife with noncompliance, participants in that sector are subject to attack by ideological enemies using the noncompliance as an opportunity to delegitimize the entity or invalidate the entity's tax-exempt status. This harm is considerably more tangible than the potential loss of the warm glow. Simply put, if the IRS allows charities to obtain tax-exempt status despite the failure to pass the Organizational Test, those charities are vulnerable. All it would take is a carefully-placed word in the right ear (e.g., a politician, the U.S. Attorney General, or someone with influence at the IRS) to initiate an action to deprive the charity of tax-exempt status.

Imagine a charity dedicated to women's health. Because it operates in a poor neighborhood and serves a small population, it anticipates low annual gross receipts and opts to use the Streamlined Application to obtain tax-exempt status. The founders of this entity are unaware of the requirements of the IRS, and they form a nonprofit corporation without the provisions required by the Organizational Test. Due to the shortcomings of the Streamlined Application, the IRS does not learn of this omission and instead bestows charitable status upon the entity. As part of a holistic approach to women's health, the organization considers offering family planning services, including abortions. Now imagine that an anti-abortion advocate hears of these plans and endeavors to hinder them. The advocate might form a picket line outside their offices or launch a marketing campaign to convince politicians to look into the entity's noncompliance with the Organizational Test. As far-fetched as this might have sounded just a few years ago, this scenario seems considerably less alarmist in an era rife with political favors and politically-motivated prosecutions. And the consequences of the revocation of tax-exempt status could be disastrous, "wreak[ing] havoc on an organization, its donors, as well its employees."[136] Revocation can be either prospective or can be applied retroactively. If the revocation is prospective, the most obvious consequence is that the entity would no longer be tax-exempt and would be subject to future federal corporate income tax, and future donors would not be able to take a tax-deduction.[137] Further, the organization might be subject to back taxes or penalties.[138] Finally, any state benefits (such as

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[136] Nicholas P. Cafardi & Jaclyn Fabean Cherry, TAX EXEMPT ORGANIZATIONS: CASES AND MATERIALS (3d ed. Lexis, 2014) 998.

[137] See *Automatic Revocation of Exemption for Non-Filing: Frequently Asked Questions*, IRS available at https://www.irs.gov/pub/irs-tege/auto_rev_faqs.pdf [https://perma.cc/Z47N-G6F3].

[138] *Amato v. UPMC Presbyterian Shad*yside, 371 F. Supp.2d 752, 756 (2005) (noting that "the tax code permits the Internal Revenue Service … to pursue civil actions against tax

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property tax exemption and sales tax exemption) would also likely be revoked.[139] Although less likely, the IRS has the ability to revoke an organization's tax-exempt status retroactively.[140] In such an event, in addition to all the negative consequences discussed above, the entity could be subject to tax liability for the lifetime of the organization.[141] And all of these potential negative consequences are due to the fact that the IRS failed to note that the entity's failure to meet the Organizational Test. If the IRS had noticed this failure at the time of application, it could have simply asked the entity to remedy the oversight and reapply for tax-exempt status.[142]

III. THE DATA

As noted above, the Streamlined Application does not require applicants to submit formation documents, rendering the IRS incapable of confirming that a particular entity complies with the Organizational Test. Given this lapse, one might reasonably hypothesize that the Streamlined Application process has awarded tax-exemption to entities that would not have passed muster if they were to have filed the Form 1023. This hypothesis was confirmed by a

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exempt organizations that contravene their tax exempt status, so as to collect back taxes or revoke an entity's tax exempt designation.")

[139] See Automatic Revocation of Tax Exempt Status, Publication 4991 (Rev. 2-2014) Catalog Number 59459X, Department of Treasury at 2 ("State and local laws may affect an organization that loses its tax-exempt status as well.").

[140] 26 U.S. Code § 7805(b). But see *Democratic Leadership Council, Inc. v. U.S.*, 542 F. Supp. 2d 63 (D.C. DC 2008).

[141] Bruce R. Hopkins, STARTING AND MANAGING A NONPROFIT ORGANIZATION (7th Ed. Wiley) 371 (noting that the IRS "has been known to grant recognition of exemption to an organization, then years later change its mind, and revoke the exemption back to the date the organization was formed, setting the organization up for a huge tax liability.").

[142] *Study of Taxpayers That Obtained Recognition as IRC § 501(c)(3) Organizations on the Basis of Form 1023-EZ*, 17 https://taxpayeradvocate.irs.gov/Media/Default/Documents/2019-ARC/ARC19_Volume1_TRRS_04_StudyExtent.pdf [https://perma.cc/7A2U-JJXD] [hereinafter Taxpayer Advocate Study] ("The National Taxpayer Advocate recommends that the IRS adjust Form 1023-EZ to require organizations to submit their organizing documents … and require a narrative statement of the organization's activities and its financial information.").National Taxpayer Advocate Study at 17 ("[T]o the extent a deficiency can be corrected by amending the organizing document, the IRS should require the applicant to submit an amendment that corrects the deficiency and has been approved by the state.").

[142] *Id*. at 17.

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study by the National Taxpayer Advocate,[143] which revealed that 37% of the study sample failed the Organizational Test[144]

The data discussed in this section confirms the National Taxpayer Advocate's conclusion that the Streamlined Application is deficient and that the IRS continues to award tax-exempt status to a substantial number of unworthy applicants.[145] The data also confirms the National Taxpayer Advocate's conclusion that very little effort would be required to remedy this failure, because it only takes a few minutes to review the organizational documents of applicants.[146] But this Article has greater aspirations beyond just confirming the findings of the National Taxpayer Advocate study. Rather, this Article endeavors to find a low-cost solution to the problem. To that end, this study reviewed organizational documents from five states (Florida, Idaho, Maryland, North Carolina, and Ohio). Each of these states has a unique approach to entity formation, and this study identifies those states that produced the highest percentage of Streamlined Application filers in compliance with the Organizational Test. By focusing on these states, the study identifies mechanisms and practices that any state might adopt to produce tax-exempt applicants that are more likely to meet the Organizational Test.

One might reasonably ask why this study focuses on the Organizational Test. After all, the operational test, which focuses on the actual activities of the organizations rather than what their formation documents say, might be a better measure of whether an applicant is worthy of tax-exempt status.[147] The reason for focusing on the Organizational Test is two-fold. First, determining an organization's compliance with the Organizational Test requires little

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[143] *Study of Taxpayers That Obtained Recognition as IRC § 501(c)(3) Organizations on the Basis of Form 1023-EZ*, available at https://taxpayeradvocate.irs.gov/Media/Default/Documents/2019-ARC/ARC19_Volume1_TRRS_04_StudyExtent.pdf [https://perma.cc/7A2U-JJXD] [hereinafter The Taxpayer Advocate Study]

[144] Id.

[145] See infra Part III, 6.

[146] *Study of Taxpayers That Obtained Recognition as IRC § 501(c)(3) Organizations on the Basis of Form 1023-EZ*, 14 https://taxpayeradvocate.irs.gov/Media/Default/Documents/2019-ARC/ARC19_Volume1_TRRS_04_StudyExtent.pdf [https://perma.cc/7A2U-JJXD] (in a similar study, the National Taxpayer Advocate noted that "it took the reviewers about three minutes on average to review an organization's articles and determine whether there were acceptable purpose and dissolution clauses. The longest it too to search for an review articles was 15 minutes (in four cases). In over 90 percent of the cases, it took five minutes or less.").

[147] In short, the operational test requires applicants to refrain from any amount of private inurement or political activity, and to limit lobbying, private benefit, and commercial activity to an amount that is considered insubstantial. [CITE]

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more than a review of the organization's formation documents. As noted above, the review takes little more than a few minutes, and thus represents a reasonable amount of work, even for an agency as resource-strapped as the IRS. The second reason is more pragmatic. The operational test requires gathering information from the applicant regarding their political activities; lobbying efforts; commercial activity; and payments to insiders, employees, and contractors. Unfortunately, the only way to procure such information would be to individually contact each charity, a process that would be prohibitively inefficient.[148]

A. *Study Methodology*

This section describes the methodology for the study. First, this section describes the data collection process. More specifically, it discusses the IRS's quarterly publications of Streamlined Application filers, and how I culled that data for the study. Second, it discusses the justifications for choosing the states included in the study. Third, this section details the process by which I determined the sample of charter documents reviewed in the study.

1. IRS Publication of Streamlined Application Data

As noted above, three years after the launch of the Streamlined Application, the IRS began publishing spreadsheets that provided detail on Streamlined Application filers.[149] Prior to this decision, there was no efficient mechanism of determining which tax-exempt entities filed Form 1023s and which filed Streamlined Applications. A boon for researchers, the data is published in an excel sheet on a quarterly basis, and includes all of the information included on the Streamlined Application, including the charity's name and mission, the names and addresses of the organization's officers and directors, and the entity's state of incorporation.[150]

Of particular interest to this Article, the published data includes the applicants' answers to questions 5, 6 and, 7 in Part II of the Streamlined Application. These questions represent the Streamlined Applicant's attempt to determine if the applicant meets the Organizational Test. The questions are as follows:

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[148] Incidentally, this is what the IRS will have to do to determine if these organizations are operating in compliance with laws. See Yin *supra* note18.

[149] *Exempt Organizations Form 1023-EZ Approvals*, https://www.irs.gov/charities-non-profits/exempt-organizations-form-1023ez-approvals [https://perma.cc/UG4L-TQ7C].

[150] *Exempt Organizations Form 1023-EZ Approval Information Sheet*, https://www.irs.gov/pub/irs-tege/f1023ez_infosheet.pdf [https://perma.cc/AP2C-J7TP].

Electronic copy available at: https://ssrn.com/abstract=3814958

5. Section 501(c)(3) requires that your organizing document must limit your purposes to one or more exempt purposes within section 501(c)(3).

    - Check this box to attest that your organizing document contains this limitation.

6. Section 501(c)(3) requires that your organizing document must not expressly empower you to engage, otherwise than as an insubstantial part of your activities, in activities that in themselves are not in furtherance of one or more exempt purposes.

    - Check this box to attest that your organizing document does not expressly empower you to engage, otherwise than as an insubstantial part of your activities, in activities that in themselves are not in furtherance of one or more exempt purposes.

7. Section 501(c)(3) requires that your organizing document must provide that upon dissolution, your remaining assets be used exclusively for section 501(c)(3) exempt purposes. Depending on your entity type and the state in which you are formed, this requirement may be satisfied by operation of state law.

    - Check this box to attest that your organizing document contains the dissolution provision required under section 501(c)(3) or that you do not need an express dissolution provision in your organizing document because you rely on the operation of state law in the state in which you are formed for your dissolution provision.

Questions 5 and 6 are designed to determine if the organization's formation documents contain an appropriate Limitation of Activities Clause, and question 7 is an attempt to ensure that the applicant's formation documents have an appropriate Dissolution Clause.

Because each of the entities listed on the published spreadsheet were granted tax-exempt status, one would hope that the applicants checked each of these

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boxes. Otherwise, the applicant would have received tax-exempt status despite a clear indication that the applicant did not meet the Organizational Test. Indeed, every one of the 500 Streamlined Application filers in this study checked these boxes, self-proclaiming to the IRS that they each meet the Organizational Test.

2. Choosing the States for the Study

Because the Streamlined Application does not require submission of formation documents, the only way to check the veracity of the applicants' answers to questions 5, 6, and 7 of the Streamlined Application is to collect and review the individual formation documents from the states in which the applicants were formed. Fortunately, such a review takes only a few minutes per applicant.[151] Unfortunately, many states charge for the service of providing formation documents. Thus, I limited the study to the twenty states that provide formation documents for free.[152]

The next step was to determine which of these twenty states should be analyzed. Because the study aims to identify specific state practices that might result in higher compliance rates, it was important to choose states with different approaches to entity formation. Ultimately, I chose to analyze the following states: Florida, Idaho, Maryland, North Carolina, and Ohio. I chose these states because they represent diversity in both geography and formation processes. With respect to the former, the selected states represent an obvious geographic diversity, with states representing the South (Florida and North Carolina), Mid-Atlantic (Maryland), Midwest (Ohio), and West (Idaho). With respect to the latter, these states offer very different levels of support in the formation process. For example, to form a nonprofit corporation in Florida, one merely goes to the Florida Secretary of State website and completes a form that elicits the organization's name, a business address, the name and address of a registered agent and an incorporator, a mission statement, and a $70.00 payment.[153] Of particular interest to this study, the Florida process never mentions the need for either a Limitation of Activities Clause or a Dissolution Clause. On the other end of the spectrum is Maryland, which has a similar formation process as Florida with one vital difference: the Maryland Secretary of State website requires filers to include standard

[151] National Taxpayer Study, supra note 142.
[152] The following twenty states provide free copies of formation documents are the following: Alaska, Colorado, Florida, Idaho, Indiana, Iowa, Kansas, Kentucky, Maryland, Massachusetts, Michigan, Mississippi, Missouri, New Hampshire, North Carolina, Ohio, Oregon, Rhode Island, South Dakota, and [Texas]. *See* National Taxpayer Advocate Study, *supra* note 142 at 9 fn 37.
[153] See https://dos.myflorida.com/sunbiz/start-business/efile/fl-nonprofit-corporation/ [https://perma.cc/XDB2-QJLD].

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versions of the Limitation of Activities Clause and the Dissolution Clause in the organization's charter document.[154] Thus, Maryland takes steps to ensure that its nonprofits meet the Organizational Test, where Florida does not. The specifics of the formation procedures of each state are outlined in more detail below,[155] but in short, (i) Florida's form contains no prompts for either Organizational Test provision;[156] (ii) Idaho splits the difference, providing a prompt for a Dissolution Clause but not one for a Limitation of Activities Clause;[157] (iii) Maryland foists a default Limitation of Activities Clause and Dissolution Clause upon each new nonprofit corporation;[158] (iv) North Carolina's form references a separate form which contains appropriate versions of the Limitations of Activities Clause and Dissolution Clause;[159] and (v) Ohio's form contains neither the Limitations of Activities Clause nor the Dissolution Clause.[160] At first blush, Ohio and Florida appear to have similar formation processes, with neither providing Organizational Test language, but I included Ohio in the study because Ohio state law requires all assets of nonprofit corporations to be permanently dedicated to the entity's charitable purpose.[161]

Thus, the states were chosen to provide sufficient diversity in formation procedures to discern whether different formation processes might influence the compliance rate for nonprofits. The hope is that although the IRS may have eschewed its duty to determine if Streamlined Application filers have met the Organizational Test, this study might chart a path for how states might step into the regulatory void and ensure that charities comply with the

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[154] See https://businessexpress.maryland.gov/ [https://perma.cc/4MYQ-G75M]
[155] See Part III, B.
[156] Florida Division of Corporations, https://dos.myflorida.com/sunbiz/ [https://perma.cc/UKN8-YKAB]
[157] Idaho Secretary of State, https://sos.idaho.gov/ [https://perma.cc/Y22C-EHP3].
[158] Maryland Secretary of State, https://businessexpress.maryland.gov/ [https://perma.cc/4MYQ-G75M]
[159] North Carolina Secretary of State, https://www.sosnc.gov/ [https://perma.cc/9RTD-VFUX]
[160] Ohio Secretary of State, https://www.sos.state.oh.us/ [https://perma.cc/BGZ2-HZKB]
[161] *See* 1702.49(D)(2) ("In the case of a public benefit corporation: (a) assets held by it in trust for specified purposes shall be applied so far as is feasible in accordance with the terms of the trust, (b) the remaining assets not held in trust shall be applied so far as is feasible towards carrying out the purposes stated in its articles, (c) in the event and to the extent that, in the judgment of the directors, it is not feasible to apply the assets as provided in above clauses (a) and (b), the assets shall be applied as may be directed by the court of common pleas of the county in this state in which the principal office of the corporation is located, in an action brought for that purpose by the corporation or by the directors or any thereof, to which action the attorney general of the state shall be a party, or in an action brought by the attorney general in a court of competent jurisdiction, or in an action brought as provided in section 1702.50 of the Revised Code for the purpose of winding up the affairs of the corporation under the supervision of the court.").

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Organizational Test. Ultimately, this study might provide what might best be described as the best practices for nonprofit state formation schemes.

3. Determining the Sample

Given the number of charities that obtained tax-exempt status with the Streamlined Application,[162] I decided to review a random sample of the organizations from each state. Using Excel's "=rand()" function (otherwise known as the Mersenne Twister), I generated random numbers between zero and one for each organization formed in a given state.[163] The entities were then sorted using the resulting random numbers, and I analyzed the first 100 for each state. With the help of the University of Tennessee College of Law librarians, I pulled the formation documents for each of the 500 entities in the sample for review. The results of the review are set forth in the following section.

B. The Data

1. Florida: The Sunshine State

True to its nickname, the Florida Department of State's Division of Corporations website is appropriately bright and colorful.[164] The upper left corner of the website features a golden yellow and orange ombré logo cheerfully welcoming visitors to "sunbiz.org." Directly below the logo is a link entitled "Start a Business," and to form a nonprofit corporation, visitors select "Non-Profit Corporation" from a pull-down menu. The entire formation process is pleasant, user-friendly, and simple.

Once on the Division of Corporations' page for forming a nonprofit corporation, a visitor has the option of reviewing filing instructions. Visitors are not required to review the instructions, but if they do, they would find them clear and to the point, including provisions that explain how to choose an appropriate name for the organization, describe the role of a registered agent, and detail why an entity might want to choose an effective date other than the filing date.[165] Importantly for this discussion, under the instruction topic entitled "Corporate Purpose," the Florida Division of Corporations cautions filers to "check with the IRS prior to filing for appropriate language for your specific situation" if the organization intends to seek 501(c)(3)

[162] In 2018, the year that I reviewed, there were 4,189 charities that obtained tax-exempt status in Florida, 330 in Idaho, 1,298 in Maryland, 1,896 in North Carolina, and 2,061 in Ohio.
[163] Or more precisely, Dr. David Gras, a colleague at the University of Tennessee Haslam School of Business, generated random numbers using the Mersenne Twister.
[164] https://dos.myflorida.com/sunbiz/ [https://perma.cc/UKN8-YKAB]
[165] https://dos.myflorida.com/sunbiz/start-business/efile/fl-nonprofit-corporation/instructions/ [https://perma.cc/XDB2-QJLD]

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status.[166] If visitors were to follow this prompt, they might learn of the provisions required by the Organizational Test. There is, however, no reference on the Division of Corporations' page to the Organizational Test beyond this vague mention of "appropriate language."

Once the visitor returns to the formation webpage from the instructions page, the visitor is presented with a fill-in-the-blank form that elicits all the information necessary to form a nonprofit corporation in the state of Florida. Notably, and despite the instructions' warning that the IRS might require additional language, there is no space for either the Limitation of Activities Clause or the Dissolution Clause on the fill-in-the-blank form. If an incorporator wanted to include such provisions, they are presumably unable to use the online form and must instead submit a paper version of the formation document in person or through the mail. This procedure, however, is not discussed on the Division of Corporations' website.

Given the inability for an online filer to include either the Limitation of Activities Clause or the Dissolution Clause in the provided form, one might expect that the Florida-based applicants (the "Florida Entities") would largely fail the Organizational Test. Unfortunately, this instinct is correct. Only 41.11% of the Florida Entities' charter documents contained provisions that met the Organizational Test.[167] Of the nearly 60% of the Florida Entities that that failed the Organizational Test, the vast majority simply neglected to include an appropriate Limitation of Activities Clause or Dissolution Clause.[168] Further, a few Florida Entities received tax-exemption despite problems more glaring and upsetting than merely failing the Organizational Test. By way of example, according to its Streamlined Application, the mission of a charity called "SWF MOPARS Plus" includes activities that "promote the Mopar brand."[169] Clearly, an organization dedicated to the promotion of a for-profit brand[170] would not fulfill the Organizational Test's requirement of being exclusively operated for charitable purposes. And

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[166] https://dos.myflorida.com/sunbiz/start-business/efile/fl-nonprofit-corporation/instructions/ [https://perma.cc/XDB2-QJLD]

[167] A detailed spreadsheet containing all study data is on file with the author. Interestingly, of the 100 organizations based in Florida that received tax-exempt status by filing a Streamlined Application, we could only confirm that 90 of the organizations were actually formed in the state. These entities are either formed in another state or not formed at all. If the latter, then the compliance rate for Florida-based Streamlined Application filers would be even lower (approximately 37%). However, due to the unknown nature of these missing entities, they did not factor into the 41.11% approval rate.

[168] A detailed spreadsheet containing all study data is on file with the author.

[169] *Id.*

[170] "Mopar" is the parts, service, and customer care division of Fiat Chrysler Automobiles.

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despite this patently impermissible purpose, this entity was awarded tax-exempt status.

Although a charity formed for the purpose of promoting a for-profit brand is clearly antithetical to any purported charitable purpose, that organization is not the most egregiously profit-motivated organization of the Florida Entities. That claim goes to a charity called "Housing Initiative of Florida Corp," an organization that claims in its Streamlined Application to "provide a pathway to homeownership to at-risk residents of Florida."[171] Despite this facially-acceptable mission statement, the entity was formed as a for-profit corporation.[172] This is troubling for a number of reasons. First, it is important to note that, as a for-profit entity, Housing Initiative of Florida Corp was not eligible to use the Streamlined Application. As the instructions to the Streamlined Application clearly state, if any organization answers "yes" to any question set forth on the Form 1023-EZ Eligibility Worksheet, the organization is "not eligible to apply for exemption under Section 501(c)(3) using" the Streamlined Application.[173] Question 8 of the Form 1023-EZ Eligibility Worksheet is "Are you formed as a for-profit entity?"[174] But beyond using an application form for which it was not eligible, a for-profit corporation's structure is incompatible with one of the fundamental characteristics of nonprofit entities: that nonprofits must not have residual owners (i.e., in the case of corporations, shareholders).[175] Thus, this organization obtained tax-exempt status from the IRS despite (i) using the Streamlined Application when it failed to satisfy the eligibility requirements of the Form 1023-EZ Eligibility Worksheet, (ii) failing to include either a Limitations of Activities Clause or Dissolution Clause, and (iii) incorrectly attesting that its formation documents contained both a Limitations of Activities Clause or Dissolution Clause.[176] Perhaps most upsetting is the fact that the IRS, with minimal review, would have easily identified the

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[171] A detailed spreadsheet containing all study data is on file with the author.

[172] See Division of Corporations Search for Corporations results for "Housing Initiative of Florida Corp" at http://search.sunbiz.org/Inquiry/CorporationSearch/SearchResultDetail?inquirytype=EntityName&directionType=Initial&searchNameOrder=HOUSINGINITIATIVEFLORIDA%20P180000312270&aggregateId=domp-p18000031227-7fe9e17e-c1ed-4b65-be12-2e9f25d7e2b5&searchTerm=Housing%20Initiative%20of%20Florida%20Corp&listNameOrder=HOUSINGINITIATIVEFLORIDA%20P180000312270 [https://perma.cc/6CLZ-CUDC]

[173] *See* Instructions to the Form 1023-EZ, available at https://www.irs.gov/pub/irs-pdf/i1023ez.pdf, at 13. [https://perma.cc/5UJ7-546W].

[174] *See* Instructions to the Form 1023-EZ, available at https://www.irs.gov/pub/irs-pdf/i1023ez.pdf, at 14. [https://perma.cc/5UJ7-546W].

[175] Hansmann, *supra* note 50.

[176] A detailed spreadsheet containing all study data is on file with the author.

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shortcomings of this application. There is little urgency to remedy this oversight, as this organization was administratively dissolved by the Florida Division of Corporations for failing to file its annual report,[177] but it provides a particularly salient example of the Streamlined Application's embarrassing failure to sufficiently vet applicants.

Ultimately, almost 60% of the Florida Entities received tax-exempt status despite the fact that the most minimal of scrutiny would have uncovered the applicants' shortcomings.[178] The IRS's failure to design an application that adequately vets applicants combined with Florida's lack of guidance regarding the Organizational Test to result in an embarrassingly low compliance rate.

2. Idaho: The Gem State[179]

Idaho's Secretary of State has a well-designed website featuring the handsome photographs of the state capitol building, freely running horses, and Idaho's "World Famous" Lava Hot Springs.[180] The page features Lawrence Denney, Idaho's Secretary of State cheerfully stating that one of his goals include "simplicity" and to provide online services to "make it easier to start and run a business in Idaho."[181] No doubt in this spirit, the process of forming a nonprofit corporation is quite simple. After a few clicks, a visitor hoping to form a nonprofit corporation quickly lands upon a user-friendly form consisting of fill-in-the-blank prompts.[182] Similar to Florida,

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[177] *See* Division of Corporations Search for Corporations results for "Housing Initiative of Florida Corp" supra note 172 (noting that the "Last Event" was "ADMIN DISSOLUTION FOR ANNUAL REPORT").

[178] A detailed spreadsheet containing all study data is on file with the author.

[179] The origins of Idaho's name is a fascinating tale of how a conjured word that sounded Indian became the name of one of the United States. In the mid 19th century, the name was proposed for the territory that would eventually become Colorado, with the incorrect understanding that "Idaho" was a Shoshone word for "Gem of the Mountain." Once Congress learned that "Idaho" was not an Indian word, it was set aside in favor of "Colorado." But a few years later, no doubt distracted by the coming Civil War, Congress adopted the name for a new territory that would become the state of Idaho. See James Dawson, How Did Idaho Get That Name? Boise State Public Radio, May 2, 2018, https://www.boisestatepublicradio.org/post/how-did-idaho-get-name#stream/0; Merle W. Wells, Origins of the Name "Idaho" and How Idaho Became a Territory in 1863 at https://digitalatlas.cose.isu.edu/geog/explore/essay.pdf [https://perma.cc/67R7-VPSW]. ("Senator James S. Green had noted that 'Idaho is a very good name. In the Indian language it signifies 'Gem of the mountains'.' Lane had dissented: 'I do not believe it is an Indian word. It is a corruption. No Indian tribe in this nation has that word, in my opinion.' Then he reemphasized his point: "It is a corruption certainly, a counterfeit, and ought not to be adopted.'").

[180] Idaho Secretary of State Website, https://sos.idaho.gov/ [https://perma.cc/Y22C-EHP3].

[181] *Id.*

[182] *Id.*

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the formation process in Idaho requires the usual formation requirements (corporate name, registered agent name and address, etc.).[183] But this is where the similarities end. Idaho departs from Florida, and perhaps succeeds where Florida failed, by including a specific reference to one of the requirements of the Organizational Test: the Dissolution Clause. After eliciting some standard information about the charity, the form provides the following choices under a topic entitled "Asset Distribution on Dissolution":

Article 5: Asset Distribution on Dissolution

Upon dissolution the assets shall be distributed: *

- ○ the residual assets of the Corporation (after all creditors of the Corporation have been paid), shall be distributed to the members prorated in accordance with their respective membership interests.
- ○ all assets will be distributed to another nonprofit organization with a similar purpose.
- ○ other asset distribution:

The tiny red asterisk indicates that the question is required. Thus, before they are even formed, nonprofit corporations in Idaho are confronted with the IRS's requirement of a Dissolution Clause, with at least one of the three choices fulfilling the Organizational Test.[184] Unfortunately, if the goal of the Idaho Secretary of State was to promote compliance with the Organizational Test, the website only meets that goal half-way, as there is no suggested language for a Limitation of Activities Clause.

If the experience in Florida is any guide, a reasonable person might assume that the organizational documents of Streamlined Application filers hailing from Idaho (the "Idaho Entities") would likely contain an appropriate Dissolution Clause but would not likely contain a Limitation of Activities Clause. This assumption is supported by the study. In the sample of Idaho Entities, the Idaho Secretary of State's prompt for a Dissolution Clause appears to have helped with compliance, as 89.61% of the Idaho Entities boasted an appropriate Dissolution Clause.[185] And perhaps due to the failure of the Idaho Secretary of State to include any prompt regarding the Limitation of Activities Clause, only 22.08% of the Idaho Entities had a sufficient Limitation of Activities Clause.[186] A handful of organizations—thirteen, to be precise—were not found on the Idaho Secretary of State website,

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[183] *Id.*

[184] The second choice fulfills the Dissolution Clause requirement of the Organizational Test. The third might also fulfill the requirement, depending on how the entity described the "other asset distribution."

[185] A detailed spreadsheet containing all study data is on file with the author.

[186] A detailed spreadsheet containing all study data is on file with the author.

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suggesting that the organizations are either formed in another state or were never formed at all.[187]

Similar to Florida, there were a number of remarkable entries. For example, there were a surprising number of unincorporated organizations that registered with the state of Idaho.[188] An unincorporated organization is one that is not formally formed with the state. In this dataset, there were ten unincorporated associations that ultimately received 501(c)(3) status through the Streamlined Application.[189] Although the Streamlined Application specifically states that it is permissible for an unincorporated association to use the form to obtain tax-exempt status,[190] there is no way to check the Organizational Test compliance of such filers because they are not required to file organizational documents with the state. Thus, although I could locate such organizations and confirmed they exist in Idaho, I did not include them in the calculation of compliance because I was unable to review their formation documents.[191]

Although a significant number of Idaho's Streamlined Application filers included adequate Dissolution Clauses in their formation documents, a number of the organizations that failed to do so are worth particular attention. For example, an organization called "Zion Church Corp," dedicated to "teach, train and equip Christians the Holy Bible and to disciple Christians to follow Jesus Christ's example of carrying for the poor, sick, and lost," boldly stated in its formation documents that upon dissolution, the assets of the charity "shall be distributed to the members prorated in accordance with their respective membership interests."[192] This is an obvious violation of the nondistribution constraint. In case there is any doubt, the Treasury Regulations specifically state that "an organization does not meet the Organizational Test if its articles … provide that its assets would, upon dissolution, be distributed to its members or shareholders."[193] Thus, this provision, which specifically permits the organization to distribute assets to its members, should serve as a glaring red flag for any reviewer. After all, under this provision, the organization could obtain tax-exempt status, solicit tax-deductible donations, institute dissolution procedures, and divide the donated funds among its members. This is a clear failure to comply with the Organizational Test, one that would be discovered by even the most cursory

[187] *Id.*
[188] *Id.*
[189] *Id.*
[190] *See* Form 1023-EX, supra note [], Part II, line 1 ("To file this form, you must be a corporation, an unincorporated association, or a trust.").
[191] A detailed spreadsheet containing all study data is on file with the author.
[192] *Id.*
[193] Section 1.501(c)(3)-1(b)(4)

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of reviews. And yet, Zion Church Corp obtained tax-exempt status through the Streamlined Application.

Sadly, this organization was not an outlier in Idaho. In a clear violation of the Organizational Test, a charity called "Twin Falls County Beef Awards Committee Inc.", dedicated to organizing an awards banquet for a livestock show, plans to distribute assets upon dissolution to "beef show participants."[194] In another example, a charity called "Central Idaho Amateur Radio Club," dedicated to promoting an amateur emergency communications system, plans to distribute all assets upon dissolution "in equal shares, among the members" of the charity.[195] And perhaps most upsettingly, the assets of a charity called "Transparensee," with a mission of educating the public on the civic matters, will distribute all assets upon dissolution to a single person, the incorporator and a director of the charity.[196] To make the obvious plain, the founder of Transparensee could raise tax-deductible donations with the express blessing of the federal government and simply keep all the funds upon dissolution. This is not only a clear violation of the Organizational Test, it is precisely what the Dissolution Clause requirement is designed to avoid– the distribution of charitable assets to insiders.

3. Maryland: The Old Line State

The Maryland Secretary of State website for business formation, like Florida's and Idaho's, is very user-friendly.[197] It is also quite welcoming, with a front page boasting a picturesque photo of downtown Berlin, Maryland, a small town of about 5,000 people near the Maryland coast with a charming main street.[198] Navigation of the website is intuitive, and a visitor will quickly find themselves in the throes of entity formation. Like Florida and Idaho, a visitor is asked to enter general information required for state formation, but Maryland takes a very different approach to the Organizational Test. Unlike Florida (which was completely silent on the provisions necessary to pass the Organizational Test) and unlike Idaho (which provided a prompt for the Dissolution Clause but failed to provide any help regarding a Limitation of Activities Clause), an incorporator in Maryland is shown the following language:

> No part of the net earnings of the corporation shall inure to the benefit of, or be distributable to its members, trustees, officers, or other private persons, except that the corporation shall be

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[194] A detailed spreadsheet containing all study data is on file with the author.
[195] *Id.*
[196] *Id.*
[197] See https://businessexpress.maryland.gov/ [https://perma.cc/4MYQ-G75M]
[198] https://www.berlinmainstreet.com/ [https://perma.cc/U4EC-JGE2]

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> authorized and empowered to pay reasonable compensation for services rendered and to make payments and distributions in furtherance of the purposes set forth in Article Third hereof. No substantial part of the activities of the corporation shall be the carrying on of propaganda, or otherwise attempting to influence legislation, and the corporation shall not participate in, or intervene in (including the publishing or distribution of statements) any political campaign on behalf of or in opposition to any candidate for public office. Notwithstanding any other provision of these articles, the corporation shall not carry on any other activities not permitted to be carried on (a) by a corporation exempt from federal income tax under Section 501(c)(3) of the Internal Revenue Code, or the corresponding section of any future federal tax code, or (b) by a corporation, contributions to which are deductible under Section 170(c)(2) of the Internal Revenue Code, or the corresponding section of any future federal tax code.
>
> Upon dissolution of the corporation, assets shall be distributed for one or more exempt purposes within the meaning of Section 501(c)(3) of the Internal Revenue Code, or the corresponding section of any future federal tax code, or shall be distributed to the federal governments, or to a state or local government, for a public purpose. Any such assets not so disposed of by a Court of Competent Jurisdiction of the county in which the principal office of the corporation is then located, exclusively for such purposes or to such organization or organizations, as said Court shall determine, which are organized and operated exclusively for such purposes.
>
> - I acknowledge that I have read the above provisions statement.[199]

This language, a basic Limitation of Activities Clause and Dissolution Clause, would easily meet the Organizational Test. Interestingly, a visitor is and presented with a check box to acknowledge the provisions, and such acknowledgment is not optional. The website does not permit a visitor to continue without acknowledging the provisions, and there is no option to *not* acknowledge the provisions. Most importantly, upon formation, these provisions are automatically included in the charter documents of nonprofits formed in Maryland. In other words, if an incorporator uses the online

[199] *See* https://businessexpress.maryland.gov/ [https://perma.cc/4MYQ-G75M]

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formation process in Maryland, it is impossible for the entity to form a nonprofit that does not comply with the Organizational Test.

As a result, one might predict that Maryland-based Streamlined Application filers will boast a high Organizational Test compliance rate. The data support this prediction, as 94.38% of Maryland's Streamlined Application filers in the dataset (the "Maryland Entities") met the Organizational Test.[200] In fact, the only organizations that failed the Organizational Test were an entity that was formed as a for-profit corporation;[201] an organization that intended to form a 501(c)(6) entity, which is the category for business leagues, such as a chamber of commerce;[202] and an organization that filed its own charter document without using the form on the Maryland Secretary of State's website.[203]

4. North Carolina: The Tar Heel State[204]

The North Carolina Secretary of State website is a bit more austere than the other states in this study, with a tastefully subtle background featuring a picturesque lighthouse peeking over reeds on the North Carolina coast.[205] The website is, appropriately, highlighted by Carolina Blue.[206] Unlike the other Secretary of State websites in this study, a visitor interested in forming a nonprofit corporation in North Carolina is not led to an online fill-in-the-

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[200] A detailed spreadsheet containing all study data is on file with the author. Like Florida and Idaho there were some organizations for which formation documents were not found on the Maryland Secretary of State website. More specifically, the Maryland dataset included eleven entities that could not be located. These entities were not included in the calculation of compliance rate.
[201] *Id*. This entity, "Wheelbound Warriors," is dedicated to providing transportation for disabled persons.
[202] *Id*. This entity is called "Veteran Women Chamber of Commerce Inc."
[203] *Id*. This entity is called "Women for Democracy and Peace in Africa."
[204] All apologies to the Blue Devils of Duke University, the Mountaineers of Appalachian State University, and the alums of any other school in North Carolina. The origin of the "Tar Heel" nickname is likely the fact that North Carolina was historically known as the leading producer of various naval stores derived from North Carolina's pine forests. Hugh Lefler H. & Albert Newsome, NORTH CAROLINA: THE HISTORY OF A SOUTHERN STATE (3d ed. 1973) ("North Carolina led the world in the production of naval stores from about 1720 to 1870, and it was this industry which gave to North Carolina its nickname.").
[205] https://www.sosnc.gov/ [https://perma.cc/CP43-ZAWL]
[206] Once again, apologies to the North Carolina-based alums and fans of schools other than the University of North Carolina.

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blank form.[207] Rather, a visitor is offered a .pdf file for completion[208] and submission either in person, traditional mail, or an online portal.[209]

Similar to the fill-in-the-blank online forms of Florida,[210] Idaho,[211] and Maryland,[212] the North Carolina form requires the nonprofit organization's name, the name and address of its registered agent and incorporator, and the address of the organization's principal office.[213] Although there is no prompt for the Limitation of Activities Clause in the document, line 7 strongly suggests inclusion of a Dissolution Clause by stating that "Attached are provisions regarding the distribution of the corporation's assets upon its dissolution."[214] To the extent an entity wished to include a Limitation of Activities Clause, line 8 provides that an attachment might contain "Any other provisions which the corporation elects to include."[215] Unique to the states included in this study, the instructions for line 7 reference a separate document, Form N-14, which provides "sample provisions"[216] for entities interested in obtaining tax-exempt status.[217] Although Form N-14 is a little out of date,[218] these provisions include language that satisfies the Organizational Test. More specifically, Form N-14 includes the following Limitation of Activities Clause:

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[207] *See supra* notes 164-203, highlighting the fill-in-the-blank forms of Florida, Idaho, and Maryland. See also, infra notes 236-262, discussing the Ohio fill-in-the blank form.

[208] See Form N-01, Articles of Incorporation for Nonprofit, available at https://www.sosnc.gov/forms/by_title/_Business_Registration_Business_Entities_Common [https://perma.cc/U8PT-3W4A]

[209] See Submitting Documents at https://www.sosnc.gov/forms/by_title/_Business_Registration_Business_Entities_Common [https://perma.cc/U8PT-3W4A]

[210] See *supra* notes 164-172.

[211] See *supra* notes 179-196.

[212] See *supra* notes 197-203.

[213] See Form N-01, Articles of Incorporation for Nonprofit, *available at* https://www.sosnc.gov/forms/by_title/_Business_Registration_Business_Entities_Common

[214] See Form N-01, Articles of Incorporation for Nonprofit, available at https://www.sosnc.gov/forms/by_title/_Business_Registration_Business_Entities_Common [https://perma.cc/U8PT-3W4A]

[215] See Form N-01, Articles of Incorporation for Nonprofit, available at https://www.sosnc.gov/forms/by_title/_Business_Registration_Business_Entities_Common [https://perma.cc/U8PT-3W4A]

[216] *Id.* ("Attach the provisions for the nonprofit regarding the distribution of assets upon dissolution. Form N-14 has sample provisions for your use as a guide.").

[217] *See* Form N-14, 1 ("The attached provisions may be incorporated by reference into articles of incorporation of a nonprofit corporation …. only if the corporation is intended to be tax-exempt under Section 501(c)(3) of the Internal Revenue Code.?

[218] The document is dated May 1997. One example of the document's age is the fact that it references "twenty-seven categories of organizations which are exempt from federal taxation." There are now 29 different categories of tax-exempt entities.

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> No part of the net earnings of the corporation shall inure to the benefit of or be distributable to, its members, directors, officers, or other private persons except that the corporation shall be authorized and empowered to pay reasonable compensation for services rendered and to make payments and distributions in furtherance of purposes set forth in these articles of incorporation. No substantial part of the activities of the corporation shall be the carrying on of propaganda or otherwise attempting to influence legislation, and the corporation shall not participate in or intervene in (including the publishing or distribution of statements) any political campaign on behalf of or in opposition to any candidate for public office. Notwithstanding any other provisions of these articles, the corporation shall not carry on any other activities not permitted to be carried on (a) by a corporation exempt from federal income tax under Section 501(c)(3) of the Code or (b) by a corporation, contributions to which are deductible under Section 170(c)(2) of the Code.[219]

Form N-14 also contains the following language, which clearly satisfies the Organizational Test's requirement for a Dissolution Clause:

> Upon the dissolution of the corporation, the Board of Directors shall, after paying or making provision for the payment of all of the liabilities of the corporation, dispose of all of the assets of the corporation exclusively for the purposes of the corporation in such manner, or to such organization or organizations organized and operated exclusively for religious, charitable, educational, scientific or literary purposes as shall at the time qualify as an exempt organization or organizations under Section 501(c)(3) of the Code as the Board of Directors shall determine, or to federal, state, or local governments to be used exclusively for public purposes. Any such assets not so disposed of shall be disposed of by the Superior Court of the county in which the principal office of the corporation is then located, exclusively for such purposes or to such organizations, such as the court shall determine, which are organized and operated exclusively for such purposes, or to such governments for such purposes.[220]

[219] *See* Form N-14, 1

[220] *Id.*

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This approach is dramatically different from the other states in this study. It is certainly a far cry from the hands-off approach of Florida, which provided no guidance with respect to either a Limitation of Activities Clause or a Dissolution Clause.[221] Further, it eschews Maryland's approach of making inclusion of Organizational Test provisions mandatory.[222] And unlike Idaho, which provided a prompt and sample language for a Dissolution Clause,[223] North Carolina provides provisions for both the Limitation of Activities Clause and the Dissolution Clause, albeit on a separate document.[224] Finally, unlike Ohio, North Carolina does not have a statutory provision that mandates the distribution of assets upon dissolution.[225]

Thus, a visitor forming a nonprofit corporation in North Carolina must download the form Articles of Incorporation,[226] download the separate form to learn about and obtain the provisions required by the Organizational Test,[227] and submit both to the North Carolina Secretary of State. Because this requires a bit more work than the other states, one might predict a lower instance of Streamlined Application filers passing the Organizational Test. However, North Carolina performed surprisingly well, with 95.45% of the Streamlined Application filers including appropriate Dissolution Clauses in their formation documents, and 80.68% of the applicants including an appropriate Limitation of Activities Clause.[228] In fact, of the five states analyzed in this study, North Carolina boasted the highest percentage of entities with appropriate Dissolution Clauses.[229] This is quite remarkable, given that Maryland's online form required inclusion of appropriate provisions, where North Carolina expects filers to consult a separate form.

Another interesting aspect of the North Carolina results is the difference between the success rate with respect to the Dissolution Clause (95.45%) and the Limitation of Activities (80.68%).[230] Even though the appropriate language for both provisions were included on Form N-14, a higher number

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[221] See *supra* notes 164-172.
[222] See *supra* notes 197-203.
[223] See *supra* notes 179-196.
[224] See Form N-14, 1.
[225] See infra note 257.
[226] See Form N-01, Articles of Incorporation for Nonprofit, available at https://www.sosnc.gov/forms/by_title/_Business_Registration_Business_Entities_Common [https://perma.cc/U8PT-3W4A]
[227] See Form N-14, 1
[228] A detailed spreadsheet containing all study data is on file with the author. Similar to the other states in this study, there were a number of entities that could not be located. Specifically, I was only able to locate the formation documents of 88 of the 100 entities in the sample group.
[229] A detailed spreadsheet containing all study data is on file with the author.
[230] *Id.*

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of entities only adopted the Dissolution Clause language.[231] This might be attributable to the fact that North Carolina's form articles of incorporation includes a specific reference to the Dissolution Clause requirement ("Attached are provisions regarding the distribution of the corporation's assets upon its dissolution"), while not specifically mentioning the Limitation of Activities Clause.[232] If this is true, there appears to be a fairly simple fix: include a specific reference to a Limitation of Activities Clause similar to the Dissolution Clause reference.

Finally, despite its high success rate, the North Carolina sample contained a few entities worth separate discussion. Of most interest to this Article is "Sticks and Stones Curling," a charity dedicated to the sport of wheelchair curling.[233] This entity apparently followed the procedures as intended, as the dissolution language mirrored the sample language provided by the Form N-14.[234] For some reason, however, the entity appended the following language to the end of the Dissolution Clause: "Any assets remaining in the hands of the Organization that constitute dues or contributions from its members, if any, shall be distributed to the contributing members, if any, pro rata."[235] This language, a clear violation of the prohibition against distributing assets to members, effectively undoes the sample dissolution language and this organization should not have been awarded charitable status. Thus, although the language provided on Form N-14 resulted in a high rate of compliance, it does not prohibit an entity from elaborating on a Dissolution Clause in a manner that results in noncompliance.

5. Ohio: The Buckeye State[236]

Although a bit less flashy than the other states in this study, the Ohio Secretary of State website is no less user-friendly.[237] Like the other online portals, the Ohio Secretary of State elicits all the necessary information for formation, including the charity's name, address, and information about the

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[231] A detailed spreadsheet containing all study data is on file with the author.
[232] Rather, the prompt indicates that "Any other provisions which the corporation elects to include are attached."). See Form N-01, Articles of Incorporation for Nonprofit, lines 7-8, at https://www.sosnc.gov/forms/by_title/_Business_Registration_Business_Entities_Common [https://perma.cc/U8PT-3W4A]
[233] A detailed spreadsheet containing all study data is on file with the author.
[234] *Id.*
[235] *Id.*
[236] See *Ohio's State Nickname*, at https://ohiohistorycentral.org/w/Ohio%27s_State_Nickname [https://perma.cc/6CN2-QJEB] ("Ohio is commonly referred to as the Buckeye State due to the prevalence of Ohio Buckeye trees within the state's borders."). Similar to North Carolina, I feel compelled to apologize to Ohioans with allegiances to schools other than The Ohio State University.
[237] Ohio Secretary of State, https://www.sos.state.oh.us/ [https://perma.cc/BGZ2-HZKB]

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registered agent.[238] In addition, a filer is given the opportunity to include "any attachment(s) that you wish to submit with your business filing."[239] A savvy filer would probably use this opportunity to include the provisions necessary to comply with the Organizational Test, but there is no indication on the Ohio Secretary of State website that this is the purpose of the attachment. Rather, a hyperlink entitled "why would I need an attachment" indicates that a filer may wish to (i) explain why the organization has a name similar to another entity (or why the organization's name uses the words "bank" or "trust"), (ii) include required forms for providing housing for youth, (iii) include something called "business information," or (iv) include more representatives of the organization.[240]

Given the results of the previous four states, the fact that the Ohio Secretary of State formation process fails to provide a sample Dissolution Clause or Limitation of Activities Clauses suggests that the Streamlined Application filers from Ohio in the dataset (the "Ohio Entities") will not likely comply with the Organizational Test. After all, the high compliance rate in North Carolina might be attributed to the Form N-14 and the prompts within the form formation document,[241] and the high compliance rate of Maryland is likely due to the mandatory inclusion of a Limitation of Activities Clause and Dissolution Clause.[242] Here, similar to Florida, there is no prompt throughout the formation process that references either the Limitation of Activities Clause or the Dissolution Clause,[243] and as one might expect, the compliance rate is very similar to Florida.[244] While 41.11% of Florida filers boasted an

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[238] Ohio Secretary of State, https://www.sos.state.oh.us/ [https://perma.cc/BGZ2-HZKB]

[239] *Id.*

[240] *Id.* The exact language in the "why would I need an attachment?" pop-up window is as follows:

> Some of the reasons to add an attachment would be in the following situations:
> * The business name you have selected is already in use in Ohio, then you must upload the Consent for Use of a Similar Name form (Click here to obtain form 590 in pdf format) to proceed with the business filing.
> * The business name contains a word such as "bank" or "trust" then you need to upload a letter from the Ohio Commerce Division of Financial Institutions to use the name.
> * The purpose of your business is to provide housing to youth, then you will need to upload a letter from the Ohio Department of Job and Family Services with approval to start your business.
> * The business information would not fit in the text fields provided on this system and you need additional space to provide additional information.
> * There are more than 3 representatives authorizing the filing of this form.

[241] See supra note 219 (discussing the Form N-14).

[242] See supra notes 197-203 (discussing the mandatory provisions included in Maryland)

[243] See supra notes 164-172 (discussing the formation process in Florida).

[244] A detailed spreadsheet containing all study data is on file with the author.

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appropriate Dissolution Clause, that number is 40.23% for Ohio Entities.[245] Similarly, exactly one-third (33.33%) of the Ohio Entities had compliant Limitation of Activities Clauses, as compared to 41.11% for Florida.[246]

However, these numbers do not tell the entire story. As noted by the instructions to the Streamlined Application, "the laws of certain states provide for the distribution of assets upon dissolution" and as such, "specific written language regarding distribution of assets upon dissolution may not be needed in those states."[247] As it happens, Ohio is one of those states,[248] along with Arkansas,[249] California,[250] Louisiana,[251] Massachusetts,[252] Minnesota,[253] Missouri,[254] and Oklahoma.[255] Each of these states have a statute that governs the appropriate distribution provision of dissolving charities, and the IRS has stated that organizations formed in those states "do not need a dissolution provision" in their formation documents.[256] With respect to Ohio's statute, when a nonprofit dissolves, any assets not held in trust "shall be applied so far as is feasible towards carrying out" the nonprofit's charitable purpose.[257] Thus, even without a Dissolution Clause in the organization's formation documents, the Organizational Test would be met if the entity had an appropriate Limitation of Activities Clause. It is important to note that the state statute does not take precedence over any contrary language in the charter, so it would be possible for an Ohio nonprofit to have an insufficient Dissolution Clause if the entity including a bespoke clause that violated the Organizational Test.[258] However, with respect to the charter documents reviewed in the Ohio dataset, there were no such conflicting dissolution provisions.[259]

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[245] A detailed spreadsheet containing all study data is on file with the author.
[246] *Id.*
[247] *See* Instructions to the Form 1023-EZ, available at https://www.irs.gov/pub/irs-pdf/i1023ez.pdf, at 5. [https://perma.cc/5UJ7-546W].
[248] *See* OHIO CODES § 1702.49(D)(2).
[249] ARKANSAS CODE §4-33-1406
[250] CALIFORNIA CORPORATIONS CODE §§6717, 8716, & 9680.
[251] LOUISIANA REVISED STATUTES §12:516 (2018)
[252] MASS GEN. LAWS Part I, Title XXII, Ch. 180, §11A.
[253] MINNESOTA STATUTES §317A.701 et. seq. (2019)
[254] Mo. Ann. Stat. Ch 352.
[255] OKLA. GEN. CORP. ACT §18-441-1201 et. seq.
[256] Rev. Proc. 82-2, 1982-1 C.B. 367, page 5.
[257] *See* § 1702.49(D)(2)
[258] *See* Instructions to the Form 1023-EZ, available at https://www.irs.gov/pub/irs-pdf/i1023ez.pdf, at 5. [https://perma.cc/5UJ7-546W] ("State law does not override an inappropriate dissolution clause. … [I]f you have an inappropriate dissolution clause (for example, a clause specifying that assets will or may be distributed to officers and/or directors upon dissolution), state law will not override this inappropriate clause.").
[259] A detailed spreadsheet containing all study data is on file with the author.

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Given the statutory default in Ohio, the low compliance rate of 40.23% with respect to the Dissolution Clause requirement is misleading.[260] Due to the statute, this number is, effectively, 100%, since only contradictory dissolution provisions in formation documents will override the state statute. Ohio does not, however, represent an absolute success story, because the Ohio Entities included a Limitation of Activities Clause at a much lower rate (33.33%).[261]

Finally, there are a number of specific entity formation documents in Ohio worth special scrutiny. For example, similar to Florida and Maryland, Ohio's dataset included a for-profit entity.[262] This entity's mission statement—to promote critical thinking, innovation, and leadership—would appear to be appropriately charitable. But due to its status as a for-profit corporation, this entity is not eligible for charitable status.[263]

6. Summary of Findings

In sum, the data set in this study included five states with five very different formation procedures. As noted above, the states in the study were chosen to provide a diversity of approaches to formation. One might imagine these states covering a spectrum of formation procedures, with one extreme providing neither sample language nor a prompt for Organizational Test language (e.g., Florida)[264] and the other extreme providing both a prompt and appropriate language (e.g., Maryland).[265] Unsurprisingly, Florida boasted a very low compliance rate and Maryland produced a very high compliance rate.[266] The chart below summarizes the differences in the formation processes for each state as well as the Organizational Test compliance rate:

[260] A detailed spreadsheet containing all study data is on file with the author.
[261] *Id.*
[262] *Id.*
[263] See *supra* notes 173-175.
[264] See *supra* notes 164-172.
[265] See *supra* notes 197-203.
[266] A detailed spreadsheet containing all study data is on file with the author.

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STATE	CHARTER DOCUMENTS AVAILABLE (OUT OF 100)	LIMITATION OF ACTIVITIES CLAUSE			DISSOLUTION CLAUSE		
		Language Provided	Prompt	Percentage Compliant	Language Provided	Prompt	Percentage Compliant
Florida	90	None	None	**41.11%**	None	None	**41.11%**
Idaho	77	None	None	**22.08%**	None	Yes	**89.61%**
Maryland	89	Mandatory language included	Mandatory language included	**94.38%**	Mandatory language included	Mandatory language included	**94.38%**
North Carolina	88	Yes, in separate form	No specific prompt	**80.68%**	Yes, in separate form	Yes	**95.45%**
Ohio	87	None	None	**33.33%**	None*	None	**40.23%**

** Note that Ohio has a statutory dissolution provision*

IV. LESSONS FROM THE DATA

The National Taxpayer Advocate concluded its study by recommending that the IRS amend the Streamlined Application to require filers to include their organizational documents.[267] Because it takes very little time to review organizational documents for compliance with the Organizational Test,[268] the assumption is that the IRS would successfully identify entities with deficient documents. However, given the desperate state of funding for the IRS,[269] it is hard to imagine the agency voluntarily taking on any additional responsibilities, no matter how slight. Thus, although the National Taxpayer Advocate recommendations are sound, they may not be feasible. And if that is true, we may need to look somewhere other than the IRS if we hope to improve the legal compliance of Streamlined Application filers. With respect to Organizational Test compliance, this study suggests that we might be able to look to state formation procedures.

The basic hypothesis is that states with less guidance regarding the Organizational Test, in terms of suggested language and prompts, will have lower rates of compliance with the Organizational Test. This hypothesis is clearly supported by the data from Florida, where a lack of either a prompt or

[267] National Taxpayer Advocate Study *supra* 21 at 17 ("The National Taxpayer Advocate recommends that the IRS adjust Form 1023-EZ to require organizations to submit their organizing documents, unless they are available online at no cost, and require a narrative statement of the organization's activities and its financial information.").
[268] *Id.*
[269] See *supra* note 10.

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suggested language resulted in some of the lowest compliance rates in the study.[270] It is true that the Limitation of Activities Clause compliance rate in Florida (41.11%) is higher than both Idaho (22.08%) and Ohio (33.33%),[271] but Idaho's Dissolution Clause compliance rate towers above Florida's (89.61% to 41.11%).[272] Recall that Idaho includes a prompt for a Dissolution Clause and completely ignores the Limitation of Activities Clause. If the hypothesis is correct, then one would expect Idaho to exhibit higher rates of compliance with respect to the Dissolution Clause and lower rates of compliance with the requirement of a Limitation of Activities Clause. As the results of the study show, this was dramatically true in Idaho, which had 89.61% compliance with the Dissolution Clause requirement and 22.08% compliance with the Limitation of Activities Clause requirement.

At first blush, Florida would seem to outperform Ohio with respect to the Dissolution Clause (Florida's 41.11% is slightly higher than Ohio's 40.23%). The only saving grace for Ohio is the state statute that automatically ensures that all nonprofits formed in Ohio comply with the Dissolution Clause requirement.[273] With a functional compliance rate of 100%, Ohio's Dissolution Clause compliance rate easily outshines Florida.[274] Thus, the results out of Florida strongly suggest that states that provide neither a prompt nor suggested language will produce nonprofit entities that are not compliant with the Organizational Test at a very high rate.

The states that provide the most interesting lessons, however, are not the states that performed poorly. Rather, the states that boasted the highest compliance rates, Maryland and North Carolina, are worth particular attention because they achieved high compliance rates with dramatically different approaches to the formation process. In short, Maryland requires all online filers to include provisions that fulfill the Organizational Test, and North Carolina refers filers to a separate form that provides suggested language for compliant provisions. Each of these states is discussed in more detail below.

With a process that requires inclusion of provisions that comply with the Organizational Test, there is little surprise in Maryland's high compliance rate of 94.38%.[275] Thus, a reasonable conclusion from the study might be to mimic Maryland's practice. After all, outside of North Carolina's Dissolution Clause compliance rate of 95.45% (more on this later), Maryland's

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[270] A detailed spreadsheet containing all study data is on file with the author.
[271] *Id.*
[272] *Id.*
[273] See *supra* note 248.
[274] A detailed spreadsheet containing all study data is on file with the author.
[275] *Id.*

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compliance rates are the highest in the study.[276] However, there is reason to be wary of the Maryland's approach. After all, the aspirations of the Organizational Test reach beyond mere compliance at formation. The intent of the Limitation of Activities Clause is to influence how the organization actually operates by, for example, eschewing propaganda and political activity,[277] and the Dissolution Clause is required in the hope that an entity will permanently dedicate its assets to charitable purposes.[278] One concern with the Maryland approach is that although requiring Organizational Test provisions in the formation process will certainly result in technical compliance, it may fail to influence the actions of organizations if the provisions were included in a thoughtless manner. In other words, if an organization includes provisions merely because a box must be checked, there's a chance that the leaders of the organization do not know or understand the content of the provisions.[279] And if the entity leaders do not know or understand the provisions, then the compliance with the Organizational Test is little more than a symbolic victory.

The North Carolina results, however, provide another model of compliance that might include more thoughtful inclusion of Organizational Test provisions. This is counterintuitive. After all, one might reasonably assume that including vague prompts with a reference to a separate document would result in, at best, middling compliance rates. Indeed, I must admit that I was not optimistic in the success rate of the North Carolina model. But North Carolina's Limitation of Activities Clause compliance rate (80.68%) is second only to Maryland (94.38%), and North Carolina's Dissolution Clause compliance rate (95.45%) barely edges out Maryland (94.38%).[280]

The North Carolina results are both surprising and encouraging. It is surprising because a sober consideration of North Carolina's formation process would suggest a low compliance rate. Or in the very least, one would reasonably expect a rate lower than Maryland, a state that literally will not let an incorporator form an entity online without inclusion of Organizational Test provisions. In sharp contrast, North Carolina's form articles of incorporation direct the incorporator to "Attach the provisions for the nonprofit regarding distribution of assets upon dissolution" and note that

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[276] *Id*. This does not include Ohio's functional Dissolution Clause compliance rate of 100%.
[277] See *supra* note 44.
[278] *Id.*
[279] Cass Sunstein & Richard Thaler, NUDGE: IMPROVING DECISIONS ABOUT HEALTH, WEALTH, AND HAPPINESS (2008)
[280] A detailed spreadsheet containing all study data is on file with the author.

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"Form N-14 has sample provisions for your use as a guide."[281] In other words, the only way an incorporator would even know about Form N-14 is if the incorporator reads the instructions to the nonprofit formation document and follows the instructions' suggestion to consult Form N-14. Further, to comply with the Organizational Test, the incorporator must create a separate document that includes the Limitation of Activities Clause and a Dissolution Clause. Thus, the success of the North Carolina approach hinges on the incorporator finding a separate form, reading it, comprehending it, drafting an attachment with the correct provisions, and including the attachment with the filing. The fact that such a convoluted process results in a success rate that rivals Maryland's process, which effectively does all this work if the incorporator merely checks a box, is, in the very least, surprising.

But however surprising, this outcome is also quite encouraging. This is especially true to those interested in ensuring thoughtful compliance with the Organizational Test. The study results strongly suggest that there are two potential models that ensure high rates of compliance with the Organizational Test: the North Carolina model and the Maryland model. Because there is a legitimate concern regarding the relative passivity required by the Maryland model, policymakers may have justifiable skepticism. For such policymakers, it is encouraging to see North Carolina maintain such a high Organizational Test compliance rate despite requiring filers to engage in extra work.

The one question posed by the study results in North Carolina is the gulf between the Limitation of Activities Clause compliance rate (80.68%) and the Dissolution Clause compliance rate (95.45%).[282] At first blush, the difference is perplexing. After all, Form N-14 includes a proposed Limitation of Activities Clause immediately before it provides the Dissolution Clause language.[283] One potential reason for the difference might be simple: the Dissolution Clause language stands alone on page 3, perhaps making it more easily copied for inclusion in the formation filing.[284] Or perhaps it is because the instructions to the formation document specifically refer to the Dissolution Clause (in bold type, no less), whereas the instructions do not specifically reference the Limitation of Activities Clause.[285] This is all,

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[281] See Form N-01, Articles of Incorporation for Nonprofit, available at https://www.sosnc.gov/forms/by_title/_Business_Registration_Business_Entities_Common [https://perma.cc/U8PT-3W4A]

[282] A detailed spreadsheet containing all study data is on file with the author.

[283] See Form N-14, Tax-Exempt Status Information, available at https://www.sosnc.gov/forms/by_title/_Business_Registration_Nonprofit_Corporations

[284] *Id.*

[285] Compare Form N-01, line 7 ("Attach the provisions for the nonprofit regarding the distribution of assets upon dissolution. Form N-14 has sample provisions for your use as a

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however, speculation. One thing we do know is that whatever North Carolina is doing with respect to the Dissolution Clause is producing more compliance than with respect to the Limitation of Activities Clause. Thus, perhaps it would make sense to include a specific reference to the Limitation of Activities Clause, similar to the reference to the Dissolution Clause in the Instructions for Completing Articles of Incorporation.[286] More specifically, we might edit lines 7 and 8 the instructions, which currently look like this:

> **Item 7** **Attach the provisions for the nonprofit regarding the distribution of assets upon dissolution. Form N-14 has sample provisions for your use as a guide.**
>
> **Item 8** Other provisions may address the purpose of the corporation, the limitation of liability, etc. per statutes in Chapter 55 of the North Carolina General Statutes.[287]

If the goal is to mimic the success of the Dissolution Clause compliance rate, we might change these lines to look more like the following:

> **Item 7** **Attach the provisions for the nonprofit regarding the distribution of assets upon dissolution. Form N-14 has sample provisions for your use as a guide.**
>
> **Item 8** **Attach the provisions for the nonprofit regarding the limitation of activities to charitable purposes. Form N-14 has sample provisions for your use as a guide.** You may also include other provisions, which may address the purpose of the corporation, the limitation of liability, etc. per statutes in Chapter 55 of the North Carolina General Statutes.

There is, of course, no guarantee that this change will result in raising North Carolina's Limitation of Activities Clause compliance rate up to its Dissolution Clause compliance rate. However, there is reason to believe that North Carolina has, intentionally or not, crafted a mechanism that is remarkably successful in creating compliance with the Dissolution Clause. There is no reason to think that a similar approach will not work for the other

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guide.") with [Cite N-01, line 8] ("Other provisions may address the purpose of the corporation, the limitation of liability, etc. per statutes in Chapter 55 of the North Carolina General Statutes.").

[286] Form N-01 *supra* note 208.

[287] Form N-14 *supra* note 208.

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half of the Organizational Test. More enticingly, there is no reason to think that other states might follow North Carolina's lead, provide similar guidance to founders of future nonprofit corporations, and help improve the overall Organizational Test compliance rate.

CONCLUSION

An underfunded IRS has proven incapable of properly vetting applications for tax-exempt status, a fact made most evident by the IRS's decision to implement the Streamlined Application, a wholly inadequate tool to measure the worthiness of aspiring charities. As a result, the IRS has awarded 501(c)(3) status to thousands of organizations that failed the Organizational Test.[288]

This does not have to be the case. Although the Congress is unlikely to begin properly funding the IRS, individual states can make change to the nonprofit corporation formation process that might help raise the Organizational Test compliance rate. More specifically, by mimicking the formation processes of Maryland and North Carolina, two states with high Organizational Test compliance rates, other states can step into the regulatory void left by the IRS.

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[288] For example, a 41.11% success rate in Florida would result in 2,467 entities that received tax-exempt status despite having insufficient provisions.

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