Compliance with Information Reporting:

Exempt Organizations[1]

Martin David* and Thomas Pollak, *Urban Institute*, and

Paul Arnsberger, *IRS/Statistics of Income*

DO EXEMPT ORGANIZATIONS COMPLY WITH REQUIRED INFORMATION REPORTING?

This question bedevils persons seeking to understand what exempt organizations do for our society. It haunts those who wish to regulate exempt organizations. This investigation presents a methodology for increasing our understanding of good-faith information reporting, and it challenges the IRS to use authority available to increase compliance with information reporting.

Scope and importance

Nonprofits provide a major part of education, health, and social welfare services. They support cultural activities, advocacy, and many professions and industries. The public knows little about the birth of nonprofits and their subsequent operation. Activity may be reported on information returns that are filed with the IRS. Information filing is waived for many small organizations and religious congregations. The need for public information about exempt organizations appears obvious. Donors would like assurance that their contributions are applied to the stated purpose of the organization. Taxpayers would like government assurance that activities of the organization have value larger than the tax that would otherwise be collected. Private businesses that compete with exempt organizations need assurance that governing boards do not enrich themselves at public expense. And citizens would like to know that tax exemption generates good value for the community and the nation.

This investigation focuses on administrative records that confer exemption and subsequent annual information reports. The perspective is demographic (Twombly 2003, Nucci 1997, and Jarmin, Klimek, & Miranda 2005). Organizations are created; they survive for a period of time; and some fail. The *IRS Exempt Organizations Business Masterfile* contains a registry of rulings that confer exemption. We use a public *extract* of this registry to find newly-formed organizations. Some organizations file information returns, which may occur before or after inclusion in the public *extract*. The demise of exempt organizations is noted on some information returns, but lapse into inactivity and dissolution is not precisely dated by the public *extract*.

BIRTHS IN THE MASTER REGISTRY

The Urban Institute *Master* datafile compiles a cumulative history of active organizations included the public *extract* at some time. *Master* contains information from applications for tax-exempt status (IRS Forms 1023 and 1024,). Religious congregations are not required to apply for exemption; they automatically are designated as 501(c)(3) organizations. *Master* contains over 1.7 million records, excluding most religious congregations. The date of the ruling that confers exempt status has been systematically included in the public *extract* since 1995.[2] The earliest rule dates in *Master* precede the Second World War. The last *extract* included in *Master* for this analysis was released in April 2004.

Urban Institute's *Master* contains all exempt organizations that were *ever* designated as active by the IRS. Some become operational; some do not. Filing annual information returns is mandated for exempt organizations with an average of more than $25,000 of gross receipts in the most recent three years (except religious and government organizations).

New organizations are defined here to *exclude:*

(a) organizations exempt under 501(c)(1),(2),(4) and higher,

(b) organizations present in the *Master* for 1989,

(c) organizations that file Form 990/990EZ more than two years before the date of their ruling (those organizations modified a prior, exempted activity), and

(d) organizations receiving exempt rulings after 2002.

These conditions limit "new" organizations to a population of 309,857 recognized as tax exempt under 501(c)(3) from 1995 to 2002. (Additional information that is pertinent to (b) and (c) appears in the Appendix.

FILING OF 990 INFORMATION RETURNS

New *Master* organizations were matched to Form 990/990EZ information returns. All fiscal years ending in the interval 1990 to 2002 were eligible for matching.[3] Matched organizations filed at least one Form 990 between 1993 and 2002. The match reveals the first tax year in which the organization filed Form 990/990EZ. Matches answer the question: What proportion of new organizations file within a specified period after the approval? Organizations approved near the beginning of our sample period (1995-2002) are at risk to file returns in more years than organizations approved in later years. Consequently, we control for elapsed time since the exempt-status ruling in the analysis.

Unmatched organizations include two populations: organizations that are not required to file and organizations that fail to comply. Legal noncompliance can not be determined from public data. We use the term noncompliance to include all organizations that delay filing for more than 12 months after the deadline. (That group includes compliant organizations with filing extensions). Noncompliance also occurs when organizations evade their filing obligations altogether. Late filing leads to a negative bias in filing rates for organizations whose first year of filing is near the end of the period, e.g. 2002. In Section 5 we distinguish nonmatched organizations that can not be located or are inactive from active organizations that may file after 2002.

FINDINGS

The methodology assures that exempt organizations display a pattern of filing that increases steadily as the number of years since the date of ruling increases. Twelve percent of the 2002 cohort began filing information returns by 2002, and they were at risk to file for one year. Half of the 1995 cohort began filing information returns by 2002, and that cohort was at risk to file for 8 years. See Table 1.

TABLE 1

Time patterns of first-filing year are similar across cohorts. See Figure 1. Depending on the cohort, between 24 and 30 percent of organizations have filed Forms 990/990EZ by the year following their exemption (labeled 2 in the figure). Three years following exemption 40 to 45 percent have filed at least one Form 990/990EZ. (Filing in anticipation of a favorable ruling is rare. It accounts for 0.02% to 1.3% of all organizations within the eight cohorts.) Differences in the history of the 1995 to 1998 cohorts are suggestive, but not statistically tested. The 1997 and 1998 cohorts appear to be on identical trajectories, and lie above the 1996 trajectory after year 3. The 1996 trajectory lies slightly above the 1995 trajectory. These differences may be a trend in increased reporting; however, that can only be certain when more years added to these few observations. Any inflation in receipts causes the fixed money threshold for filing 990 returns to capture an increasing share of the burgeoning exempt organization population.

FIGURE 1

Prevalence of filing 990 returns varies substantially within each cohort. The *National Taxonomy of Exempt Entities* (NTEE) is used to classify 12 major sectors. Table 2 shows filing rates for those sectors, separately for the 1995 and 1996 cohorts. *Max* (column 3) is the largest filing rate achieved by each major sector. Mutual membership, public benefit, and health organizations rank in the top 4 of the 12 sectors in both years. Religious organizations have the lowest rank, as most congregations are not required to file.[4]

TABLE 2

Average (column 4) is a simple average of the cumulative probabilities of filing over the years available for each cohort. Obviously, *Average* imparts less information than *Max*. It follows that new organizations contribute proportionately less information on Form 990/990EZ returns than organizations established before 1995. The number of new organizations (column 5) varies widely across NTEE sectors, and by cohorts. The precision of estimates depends on the number of new organizations, and the time patterns are less reliable for sectors that spawn only a few new organizations from 1995 to 2002.

Figure 2 shows the time pattern of filing for selected major sectors of the 1995 cohort. Health and religious organizations show the development of the differences commented on in Table 2. The truncated graph for mutual membership organizations stresses the difficulty of estimating the whole time profile when less than 100 new organizations are created in a sector in a given year. No mutual membership organizations began filing later than three years after their exemption was approved.

FIGURE 2

The waiver of information filing for churches can be related to these statistics. About two-thirds of religious organizations on the *Master* declare that they are legally exempted from filing; only three percent of that group subsequently files Form 990. The 63 percent that remain are compliant organizations. When they are added to the proportion that ever filed in figure 2, three-fourths of the sector is accounted for by 2002.

Figure 3 offers a visual picture of *Max* in table 2. It confirms similarity of filing by the 1995 and 1996 cohorts.

FIGURE 3

Conclusions and interpretation

Entrants into the nonprofit sector are incompletely represented by statistics from Form 990. A positive view of these findings is that after a "shakedown" period of three years, at least forty percent of 501(c)(3) organizations have filed an information return. Most large organizations file and financial information on their returns covers a disproportionate share of the total value in the sector. Organizations that are tiny in financial scope and activity can be ignored.

The negative view is that 55-60 percent of new nonprofits are invisible three years after their exemption has been granted. We can not infer that all are small. Some are large religious organizations exempt from reporting. Low-reporting rates may result from compliance, filing thresholds, or filing extensions. They may result from noncompliance. Evidence available from Form 990 filing suggests that filing practice does not serve the public with timely information. Whether as a result of extensions or noncompliance, seventy percent of *all* organizations fail to file within the five-month interval permitted after the end of the accounting year.[5] The absence of aggressive pressure on large organizations to file in a timely way creates doubt that all organizations feel it is important to inform the public. Some organizations may feel no obligation to file information returns.

Figure 1 reveals dynamic behavior of newly exempt organizations. The proportion of organizations that have *ever filed returns* differs from the cross-sectional proportion of exempt organizations that file in any given year. Four factors transform the estimates considered here to cross-sectional estimates. First, any year contains a mix of filing organizations that first filed at each elapsed time shown in Figure 1. Second, some will not file, although they filed in an earlier year. Third, more recent cohorts are larger than the earlier cohorts, so a weighted average of the dynamic rates is less than the average calculated in table 2. (The appendix gives more information on growth in 501(c) organizations.) Fourth, the behavior of cohorts that are more than eight years beyond their initial exemption ruling must be averaged with the new cohorts shown here to arrive at a cross-sectional filing rate.

THE RIGHT QUESTION?

The estimates presented answer the question: What proportion of "new" organizations ever file a Form 990? They use the number of organizations exempted in a particular year as the denominator in calculating the rate of filing. A different question is: What proportion of "active" organizations in a cohort ever file a Form 990? With the passage of time, some exempted organizations cease to be active.[6] Examining successive versions of the public *extract* reveals organizations that disappear from the *extract*. A few organizations indicate that their Form 990 is the final return. The organization is then dropped from the *extract*. Organizations that can not be located or are deemed inactive also are removed from the *extract*. That occurs after organizations fail to respond to follow-up letters and telephone calls. Contact information is updated every three years. That interval implies uncertainty about the year in which non-filing organizations cease operations. It could be the first year after a positive response to the follow-up cycle, or as much as three years after a positive response to the follow-up cycle.

Ambiguity in year of failure confounds estimates the number of active organizations in the 1995-2002 cohorts. By April 2004, 8,515 of the 309,857 organizations studied here had been reclassified as inactive or unable to locate. 1,041 organizations ceased operations, became inactive or could not be during the 1995-2002 period.[7] How many of the remaining 7,474 should be considered failed at the end of 2002? Since organizations that cannot be located are not designated inactive until three years after last contact, it is likely that many of these organizations actually failed during the 1995-2002 time window. If we assume all 8,515 organizations failed within the period, we can calculate an upper bound for the proportion of active organizations that have ever filed by 2002. Ever filed rates for active organizations are about 3 percent larger than rates based on all organizations. The adjustment factor varies by birth cohort, as exposure to the risk of failure is the greatest for the 1995 cohort and the least for the 2002 cohort. The adjustment factor also varies by year, as failures are more prevalent in recessions. Variation by cohort is shown in Table 3.

TABLE 3

THE FUTURE

Information about 501(c)(3) organizations can be made more comprehensive. Four imperatives are being discussed by the Senate Finance Committee (*Staff White Paper* 22 June 2004), the IRS, and leaders of the nonprofit sector:

(a) Improve follow-up of non-filers.

(b) Create incentives for organizations to inform the public.

(c) Require electronic filing of Form 990/990EZ.

(d) Revise forms and letters used by the IRS to make them “user friendly”.

Some nonprofit sector researchers argue that the current triennial follow-up of non-filers is ineffective. Tracing organizations 36 months after a ruling often fails because organizations relocate headquarters, change officers named in the Form 1023/1024 application, and change telephone contacts. Boris and Lampkin (2004, p.6) propose an annual cycle. Long experience with following individuals and organizations in panel surveys confirms that annual or semiannual follow-up is necessary to keep contact information current (Biemer and Lyberg 2003). Boris and Lampkin recommend that organizations failing to e-file essential contact information, *as that information changes*, be dropped from the *extract*. Whatever mode is used to follow up exempted organizations, Form 1023/1024 and follow-up letters need to elicit more routes for future contact. Each organization should designate *multiple* contact persons, their home and a second (work, associate) address for each, and e-mail address(es), beyond the single contact person, mailing address, and web address now requested.

The authors of the *White Paper* recommend termination of exempt status as a penalty for failure to file requested information for two years. They contend that this is appropriate as an *obligation to disclose* comes with the *privilege exemption* from taxation. Forestalling loss of exemption is feasible for any organization with competent accountants.

The *White Paper* also endorses e-filing for the sector. The Urban Institute has empowered e-filing. NCCS, in concert with stakeholders, developed an electronic filing capability, which could be used to file Form 990-EZ [2003]. Electronic became available to file Form 990 [2004] this year. Secondly, NCCS has convened regulators and accountants for exempt organizations to devise a reporting protocol that meets the needs of both Federal and state agencies. The availability of an agreed upon protocol for filing obviates the need for separate filings to the state and Federal governments and assures that e-filing suffices for both Federal and state purposes. Electronic filing of returns and follow-up information will reduce the burden of reporting and improve the quality of the information offered. Completeness of the response, and increased consistency of items of information provided can be assured by software (Couper and Nicholls 1998).

Lastly, “usability testing” and “cognitive analysis” greatly reduces confusion and ambiguity that is embedded in the current forms. One example is the "Number of employees" question, which appears in Part VI rather than Part II where expenses associated with employees are reported. Top-performing web designers and survey data collectors now require this kind of testing for web-based data collection and paper forms. (See Blessing, et al. 2003 for application and references.)

The analysis presented demonstrates the value of tracking exempt organizations from their formation to their dissolution. It reveals that more frequent follow-up of nonfiling organizations could enhance our understanding of the degree to which information returns are filed by active organizations. Lastly, it raises an important public policy question. Is more timely filing important to public oversight of exempted organizations? We have no answer to this question, but it is clear that at most one more year of information could be added to the analysis presented, implying that understanding what happens in the exempt sector lags activity of the sector by more than two years.

Widespread use of electronic filing will enhance the value of information reporting by exempt organizations. It will improve accuracy of reported information. it will create a body of information that is more accessible to the public. It should reduce the compliance cost of information filing, as the electronic filing encompasses both Federal and State requirements.

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ENDNOTES

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[1] Address correspondence and questions to mdavid@ui.urban.org

[2] Urban Institute public *extracts* do not contain ruledates before 1995. However, date of exempt ruling has been included in the *IRS Exempt Organizations Business Masterfile* since1960.

[3] IRS Return Transaction Files show tax year and end date for the organization accounting year. Returns for 1990-1992 provide evidence to exclude pre-existing organizations from our analysis. (See the appendix.) 2002 was the most recent year available at the time of this analysis.

[4] Unclassified organizations have a lower prevalence, but that is a deficiency in the data. Any organization that files information returns supplements information used to classify the organization at the time of application for exempt status.

[5] Tabulations by the National Center for Charitable Statistics (See Boris and Lampkin, 2004). The statistic does not distinguish extensions and noncompliance. The public need for timely information is compromised by filings that take more than 12 months after the stipulated deadline.

[6] A random sample of 300 nonfiling organizations revealed that 14% had failed and another 7% could not be located. See IRS (December 1994).

[7] One-sixth (161) of these organizations ever filed Form 990. The remaining five-sixths (880) were dropped from the public *extract* by inability of IRS to follow the organization.

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APPENDIX

All "births" compared to 501(c)(3) births

Cohorts of organizations that obtained rulings after 1994 and before March 2004 include about 422,000 organizations.[7] However, both newly created organizations and on-going organizations whose exempt status was modified (for example, to reflect a change in applicable code section) are included in this count. The distinction will be clarified below.

TABLE A1

Table A1 displays the count of approvals by calendar year. Two features stand out. The number of approvals grew steadily from 1995 until 2002. Second, 501(c)(3) public charities and foundations constituted 86 percent of approvals in 1995. That proportion increased to 90 percent in 2003, implying that 501(c)(3) organizations are increasingly dominant among all exempt organizations.

A scatter plot of monthly approvals appears in Figure A1. The number of approvals varies substantially within each year, and shows little seasonal variation. The trend of approvals is deceptive. Approvals increased by 190 approvals per month over the months from January 1995 to October 2002. That linear trend accounts for 43 percent of the total variance in approvals. However, the trend arises entirely from exemptions granted to 501(c)(3) organizations. Neither (c)(4) nor other exempt organizations show a significant trend in exemptions. The trend in (c)(3) approvals accounts for 94 percent of the variance in (c)(3) approvals over the period. See Figure A2.

FIGURES A1 AND A2

All rulings in the period 1995-2003, compared to "new" rulings

The gross figures above overstate the number of "new" organizations. A determination that an organization is exempt may be required for an *on-going* organization. 9,300 organizations with rulings in the period of interest, 1995-2003, appear in the *Master* registry for 1989. Clearly, these organizations operated prior to the "birth" of other organizations from 1995-2003. That indication of pre-existing organizations is the visible part of a larger problem. When organizations make substantive changes in their legal identity, a new employer identifying number (EIN) is assigned. Continuing organizations that receive new EIN's cannot be detected in the *Master* registry. "Apparently new" can not be distinguished from "actually new" organizations.

Information return filing prior to the ruling date

Inclusion of years prior to the year of the ruling (condition c, on page 2) conforms to IRS procedure. All organizations must obtain an employer identification number prior to, or at the time of, application for exempt status. The date at which IRS receives the EIN is recorded as *established_prd*. At the organization's request, the Exempt Organizations Division may then confer an "advanced ruling" that allows the organization to begin operations and accumulate a record necessary to obtain a formal ruling that the organization is exempt. Occasionally, organizations file information returns prior to the ruling date to document their activity and confirm that operations lie within the scope of exemption under the subsection of 501(c) that is requested.

The public *extract* does not disclose *established_prd.* So analysis excluded organizations filing prior to two years in advance of the ruling date. Organizations *may* file Form 990 information return *before* they receive exempt status. They may defer the request for exempt status for as much as 27 months after they begin operations. 839 organizations are excluded by the two-year cutoff; most of them filed returns for many years prior to the cutoff. Conversely, those organizations are a one-sixth of those filing before the year of the ruling.

Investigation of *established_prd* confirms that two years in advance of the ruling date includes 85% of the "new" organizations exempted in the years 1995-2003. 14,000 of 349,000 organizations (inclusive of 501(c)(4)+ and not appearing in the 1989 registry) began filing 3 years prior to the ruling date; 40,000 filed 4 or more years prior.