

Is the New Form 1023EZ Too Easy? Part II - What the Experts Think

09.11.14 | Linda J. Rosenthal, JD



"It's easier to get tax-exempt status under Form 1023-EZ than it is to get a library card," says Tim Delaney, the President and CEO of the Council of Nonprofits about the new exemption-application alternative for smaller organizations.

While that may be a bit of an overstatement, there's no question that the 3-page "Streamlined Application for Exemption from Tax under Section 501(c)(3) of the Internal Revenue Code" is much easier to prepare than the complex, 26-page, standard Form 1023.

And the differences are much more than page length alone. "The three-page form, . . . mostly asks applicants for contact information, intended charitable activities, and a list of their board members (I)t asks applicants to verify that they have forms and policies in place, but does not require applicants to provide copies of the forms and policies" including the key governing documents; that is, the articles of incorporation and the bylaws.

Nor is the organization required to submit detailed information about its actual and proposed purposes and activities. Instead, the signer of the Form 1023-EZ, on behalf of the organization, attests to certain legal conclusions – primarily, that the organization will be organized and operated in compliance with Section 501(c)(3) of the Internal Revenue Code.

Almost a Self-Certification System

The bottom line is that the Form 1023-EZ omits the usual information and documents that the Exempt Organizations Division of the IRS currently needs and relies on to perform "due diligence" before issuing the determination letter that transmits the approval of the application for tax-exempt status.

One analyst makes the observation that the new procedure is akin to a "self-certification system."

“Since its release several months ago, the Form [1023-EZ] has received widespread criticism in the philanthropic community, concerned that the process is nothing more than a rubber stamp. . . .”

Rationale of New Procedure

Both before and after the formal launch of the Form 1023EZ at the beginning of July 2014, the IRS has promoted it as reasonable and workable. It solves two key problems, explains the Commissioner of Internal Revenue, John Koskinen: (1) the burden of the complexity of the standard Form 1023, especially for smaller, simpler organizations; and (2) the huge backlog (60,000+) of pending tax-exemption applications causing approval delays averaging at least a year or more.

He explains: “This is a common-sense approach that will help reduce lengthy processing delays for small tax-exempt groups . . . We believe that many small organizations will be able to complete this form without creating major compliance risks.”

Drastically cutting the approval time, Koskinen continues, is a benefit not only to the applicant-organization but to society as well. “They can focus on their important work” right away.

The Commissioner acknowledges that there will be little up-front review of the applicants’ proposed structure and activities, but defends the new procedure: “(It) allow(s) us to devote more compliance activity on the back end to ensure groups are actually doing the charitable work they apply to do.”

Two more points: First, there will be an upfront sampling of applicants who will be subjected to a more comprehensive front-end review than usual for the Form 1023-EZ. It is intended to thwart would-be wrongdoers. Second, since the process is much simpler, it will allow small organizations without the funds for professional assistance to get the ball rolling and collect some donations.

Unspoken, of course, is the elephant in the room: The long delays could have been alleviated with increased funding and staff, but Congress won’t do that – at least in the short term. The Commissioner’s point is that the Exempt Organizations Division is doing the best it can under difficult circumstances. It’s not a perfect plan, but it will work out. At least, that’s what they’re thinking and hoping.

Increased Risk of Fraud and Misuse of Funds

Critics of the new Form 1023-EZ applaud the IRS for attempting any kind of fix for these serious problems, but they still have reservations: “Some see this abbreviated form as an invitation to abuse of charitable status, with the IRS lacking the documentation to evaluate the facts.”

The IRS has “long tried to find more efficient ways to catch bad actors while allowing good charities to get on with their programs.”

So the main concern about the Form 1023-EZ procedure is that bad actors can and will *intentionally* apply for a 501(c)(3) tax exemption when they know or reasonably should know that they will not qualify. The IRSs’ adopted solution, these critics conclude, “...is too broad to accommodate ease of applying and processing applications while also protecting taxpayers from unscrupulous and ill-prepared applicants for tax exemption.”

State charity regulators are concerned as well. They have “sternly warned the IRS” that “the Form 1023-EZ will increase opportunity for fraud and heighten the burden on state regulators.”

A Trap for the Unwary

There is also worry in the philanthropy community that applicants with good-faith intentions can and will unintentionally run afoul of the 501(c)(3) rules – with severe consequences for them in the long-run.

For instance, if an organization is planning to have an income-producing activity, and the person completing the Form 1023-EZ reads the instructions about unrelated business income but believes that the proposed activity does “contribute importantly” to its exempt purpose, what are the consequences if the IRS later decides that the activity is unrelated? Will the IRS revoke the exemption? (During the application process of a standard Form 1023, the organization discloses the details of its exempt purposes and of the proposed activities, and the IRS makes a fact-specific, pre-approval decision about the proposed business activities. Under the Form 1023-EZ procedures, there would be no such advance review.)

Consider another example. The eligibility criteria to apply under the Form 1023-EZ includes an annual revenue limit of \$50,000 in the first few years. What if an organization reasonably believes that its modest revenue will continue for the first 2 or 3 years – or indefinitely – but its fundraising is more successful than predicted? What happens then? “Will its exempt status be revoked? Will its initial exemption letter be viewed as somehow contingent on continued compliance (at least during the first few years) with the Form 1023-EZ filing criteria...?”

Conclusion

The jury is – and will remain – out. Whether this stop-gap plan solves what ails the 501(c)(3) application process, or whether it will be a mere bandaid that hides a festering problem underneath, remains to be seen.

It’s likely that the availability of the Form 1023-EZ for so many applicants will give the IRS some breathing room to clear out the large backlog of pending cases. But just as this happens, there will be a growing stack of back-end compliance audits for the newly approved Form 1023-EZ applicants that will need attention.

In this era of budget cuts — and with the Exempt Organizations Division on the firing line of Congress for other perceived faults — there will be no relief. The front-end approval pileup may be replaced by an equally burdensome back-end compliance-review clog.

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