

# A LOOK AT THE NEW DRAFT FORM 1023-EZ

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The Treasury has produced a new, vastly simplified version of the Form 1023 "Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code," called Form 1023-EZ, "Streamlined Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code." On 3/26/14, Treasury submitted the new form to the Office of Management and Budget for review under the Paperwork Reduction Act of 1995.<sup>1</sup> The following month, a revised Form 1023-EZ was issued<sup>2</sup> and the IRS publicly stated its intention to put the Form 1023-EZ into effect by the summer.<sup>3</sup>

Proposed Form 1023-EZ arrives in the midst of a staggering backlog of exemption applications currently pending at the IRS. Practitioners report that it is now common for new organizations to wait two years or more before receiving a ruling on their exempt status. In the face of this backlog, the proposed Form 1023-EZ would radically change the process of applying for Section 501(c)(3) status to something resembling self-certification (with more emphasis supposedly placed on enforcement through audits<sup>4</sup>). While in its current form, the draft Form 1023-EZ nominally would apply

only to certain types of small organizations, practitioners think the effects of the new form could be far-reaching.<sup>5</sup>

## Basic concept of the new draft Form 1023-EZ

The proposed draft Form 1023-EZ would replace the 26-page standard Form 1023 (including Schedules A-H) with a 3-page form for certain eligible organizations (see below). The standard Form 1023 includes numerous probing questions about the applicant's specific activities, and requires the applicant to submit a narrative description, financial data, and specific governing documents such as the articles of incorporation, bylaws, conflict of interest policy, and copies of contracts with officers, directors, and service providers. Form 1023-EZ, by contrast, would require no documents, and mainly would require the applicant to check various boxes attesting that it has complied with the rules governing Section 501(c)(3) status.

## Eligibility to submit Form 1023-EZ

The draft Form 1023-EZ instructions spell out with precision the types of organizations that would be ineligible to apply for Section 501(c)(3) using the Form 1023-EZ. Organizations fitting



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any one or more of the following criteria *would not* be able to use the Form 1023-EZ and would have to use the standard Form 1023 instead:

- An organization with projected annual gross receipts expected to exceed \$200,000 in any of the next three years or with annual gross receipts that exceeded \$200,000 in any of the past two years.
- An organization with total assets in excess of \$500,000.
- A foreign organization.
- An organization that is a successor to, or controlled by, an entity suspended under Section 501(p) (relating to terrorist organizations).
- A limited liability company.
- A successor to a for-profit entity.
- A previously revoked organization or a successor to a previously revoked organization (other than automatic revocation for failure to file Form 990, "Return of Organization. Exempt From Income Tax").
- A church or a convention or association of churches described under Sections 509(a)(1) and 170(b)(1)(A)(i).
- A school, college, or university described under Sections 509(a)(1) and 170(b)(1)(A)(ii).
- A hospital or medical research organization under Sections 509(a)(1) and 170(b)(1)(A)(iii).
- An organization applying for exemption as a cooperative hospital service organization under Section 501(e).
- An organization applying for exemption as a cooperative service organization of operating educational organizations under Section 501(f).
- An organization applying for exemption as a charitable risk pool under Section 501(n).
- A supporting organization described under Section 509(a)(3).
- An organization that, as a substantial purpose of its activities, provides assistance to individuals with credit counseling activities such as budgeting, personal finance, financial literacy, mortgage foreclosure assistance, or other consumer credit areas.
- An organization that invests or plans to invest more than 5% of its assets in hedge funds.
- An organization that participates in joint ventures, including partnerships or limited liability companies treated as partnerships, in which it shares profits and losses with partners other than Section 501(c)(3) organizations.
- An organization that sells or intends to sell carbon credits or carbon offsets.
- A health maintenance organization.
- An accountable care organization, or an organization with activities that include accountable care organization activities.
- A sponsoring organization as defined in Section 4966(d)(1) that maintains or intends to maintain one or more donor-advised funds.
- An organization organized and operated exclusively for testing for public safety that is requesting a foundation classification under Section 509(a)(4).

It should be noted that there is currently no method for verifying the eligibility criteria specified in the instructions. Applicants would simply attest that they have completed an "eligibility worksheet" that confirms their eligibility to use the Form 1023-EZ. There would be no requirement to submit the worksheet, and no way of checking the accuracy of an applicant's projections of annual revenue. Neither would

<sup>1</sup> 79 Fed. Reg. 18,124 (2014).

<sup>2</sup> This article analyzes the revised draft Form 1023-EZ and accompanying instructions that is current as of the time of this writing, but subsequent revisions to the Form and instructions are likely before it is finalized.

<sup>3</sup> "IRS to Roll Out Form 1023-EZ in Summer, Anticipates Little Risk of Noncompliance," Bloomberg BNA (4/25/14), available at [www.bna.com/irs-roll-form-n17179889907](http://www.bna.com/irs-roll-form-n17179889907).

<sup>4</sup> *Id.* ("Rather than placing extensive resources on reviewing the applications when the applicant is only telling the IRS what it plans to do, [Sunita] Lough [IRS commissioner of Tax-Exempt and Government Entities] said it makes more sense to review the activities once they are operational. There will be a robust compliance process at the back end, whether it be through compliance checks or full examinations, she said.")

<sup>5</sup> Comment Letter by the National Council of Nonprofits, 4/30/14 ("[W]e are concerned that the proposed new Form 1023-EZ and related streamlined approval process for tax-exemption will (1) decrease, rather than improve, the quality of information the IRS needs to make informed decisions; (2) reduce public trust; and (3) inappropriately shift the IRS' obligations onto others—foisting burdens on the public, existing charitable nonprofits, the funding community,

and state charity regulators."). See [www.councilofnonprofits.org/files/downloads/1023%20EZ%20Comments%20-%20National%20Council%20of%20Nonprofits.pdf](http://www.councilofnonprofits.org/files/downloads/1023%20EZ%20Comments%20-%20National%20Council%20of%20Nonprofits.pdf).

<sup>6</sup> Form 1023, Part II. IRS agents insist that the articles of incorporation provided show the state government's stamp of certification.

<sup>7</sup> Form 1023, Part III.

<sup>8</sup> Draft Form 1023-EZ, Part II, Lines 3-7.

<sup>9</sup> Form 1023, Part IV.

<sup>10</sup> Form 1023, Part I, Line 9.

<sup>11</sup> Draft Form 1023-EZ, Part III, Line 1.

<sup>12</sup> Draft Form 1023-EZ, Part III, Line 2.

<sup>13</sup> Draft Form 1023-EZ, Part I, Line 9.

<sup>14</sup> Form 1023, Part V, Line 1.

<sup>15</sup> Form 1023, Part V, Line 2a.

<sup>16</sup> Form 1023, Part V, Line 3a.

<sup>17</sup> Form 1023, Part V, Lines 4-9.

<sup>18</sup> Draft Form 1023-EZ, Part III, Line 3.

<sup>19</sup> Draft Form 1023-EZ, Part III, Line 5.

<sup>20</sup> Draft Form 1023-EZ, Part III, Line 6.

there be a way to verify a lack of planned activities that would affect eligibility, such as participation in joint ventures, investment in hedge funds, sponsorship of a donor-advised fund, or qualification as a public charity based on supporting organization status under Section 509(a)(3). It remains to be seen whether there would be consequences to underestimating revenue or modifying activities after Section 501(c)(3) status was obtained. The IRS has not yet provided a draft of the "eligibility worksheet."

### Comparing the standard Form 1023 with draft Form 1023-EZ

As mentioned above, the draft Form 1023-EZ replaces the rigorous question and documentation process of the standard Form 1023 with a short questionnaire that relies on the applicant's representations as to whether the rules governing Section 501(c)(3) organizations have been satisfied. A look at some of the major issues covered by the standard Form 1023 reveals how dramatic this change would be.

**Organizing documents.** Form 1023 requires the applicant to confirm that it has filed articles of incorporation and adopted bylaws, and applicants are required to attach copies to the application.<sup>6</sup> Additionally, the articles of incorporation must have a properly drafted purpose clause, and language providing that, upon dissolution, any remaining assets will be used exclusively for Section 501(c)(3) purposes.<sup>7</sup> The IRS reviews the applicant's governing documents to make sure these provisions are present and sufficiently drafted.

The draft Form 1023-EZ would ask for the date and state of incorporation, and prompt the applicant to check boxes attesting that proper purpose and dissolution language was present.<sup>8</sup> The applicant would not have to provide copies of the articles of incorporation or bylaws.

**Exempt purpose test.** To ensure that the applicant is organized for a purpose consistent with Section 501(c)(3) status, Form 1023 requires a narrative description of past, present, and planned activities.<sup>9</sup> The narrative enables the IRS to check whether the planned activities are consistent with one of the types of entities eligible for Section 501(c)(3) status, and whether the described activities raise issues under rules such as the commerciality doctrine and the restrictions on private benefit and private inurement. The Form 1023 also asks for the applicant's Web site address (if available)<sup>10</sup> and, in the author's experience, IRS

agents routinely check the Web site to verify the representations made in the narrative.

The draft Form 1023-EZ would require the applicant to fill in the applicable three-character National Taxonomy of Exempt Entities (NTEE) Code (e.g. "A60—Performing Arts Organizations," "B05—Research Institute and/or Public Policy Analysis," "C36—Forest Conservation").<sup>11</sup> The applicant would have to check a box attesting that it fits within one of the proper types of Section 501(c)(3) organizations (i.e., charitable, religious, educational, scientific, literary, testing for public safety, fostering national or international sports competition, or prevention of cruelty to children or animals).<sup>12</sup> In addition, draft Form 1023-EZ would ask for the applicant's Web site address (if available).<sup>13</sup>

**Private benefit and private inurement.** The Form 1023 asks many probing questions designed to bring to light any instances of impermissible private benefit (any benefit to a private party that is more than incidental to the organization's public benefit), and private inurement (any transaction that results in an outsized benefits to directors, officers, and other insiders of the organization). For example, Part V of Form 1023 requires reporting of compensation and other financial arrangements with officers, directors, trustees, and the most highly compensated employees and independent contractors.<sup>14</sup> It also requires the disclosure of family and business relationships among officers, directors or trustees, and the most highly compensated employees and independent contractors.<sup>15</sup> Additionally, the applicant must list the qualifications, average hours worked, and duties of these individuals, presumably to demonstrate that the officers and directors actually participate rather serving in name only, and to show that any paid positions have commensurate duties.<sup>16</sup> Part V also inquires into the applicant's processes and procedures to ensure that the applicant follows a conflict of interest policy (a sample of which is provided in the Form 1023 instructions) and that any transactions with insiders are subjected to adequate due diligence procedures.<sup>17</sup> Finally, Part VI requires similar disclosure of benefits provided to the applicant's members or other individuals or organizations.

In contrast, draft Form 1023-EZ would prompt the applicant to attest that "net earnings do not inure in whole or in part" to the benefit insiders, and that the activities do "not further non-exempt purposes (such as purposes that benefit private interests) more than insubstantially."<sup>18</sup> The draft instructions currently do not

include any additional explanation of these complex and subtle issues, so it is questionable whether an applicant would truly know to what it is attesting. The draft Form 1023-EZ also asks whether the organization pays compensation to any officers, directors, or trustees;<sup>19</sup> whether the organization donates funds or pays expenses to individuals;<sup>20</sup> and whether the organization engages in other financial transactions with officers, directors, trustees or other entities that they own or control.<sup>21</sup> Interestingly, these activities are permissible for Section 501(c)(3) organizations if conducted properly. It is unclear what the consequences of checking “yes” will be, since there is no opportunity on the draft Form 1023-EZ to provide further information or explanation.

**Political and lobbying activity.** Form 1023 inquires whether the applicant “supports or opposes candidates in political campaigns” (which is prohibited) or “influences legislation” (which is permitted subject to limits).<sup>22</sup> If the answer is “yes,” a written explanation is required.<sup>23</sup>

The draft Form 1023-EZ would prompt the applicant to attest that the organization “refrain[s] from supporting or opposing candidates in political campaigns in any way.”<sup>24</sup> The draft also would ask whether the applicant plans to “influence legislation” and, if so, suggests that it file Form 5768 (“Election/Revocation of Election [under Section 501(h)] by an Eligible Section 501(c)(3) Organization To Make Expenditures To Influence Legislation”).<sup>25</sup> The major difference here is that there is no requirement or opportunity to provide additional explanation.

**Revoked organizations and effective date of exempt status.** Part VII of Form 1023 asks whether the applicant is a successor to another organization or a for-profit entity,<sup>26</sup> and requires an additional schedule for applicants that answer “yes.”<sup>27</sup> This additional information helps the IRS ensure that organizations applying for Section 501(c)(3) status are sufficiently independent, rather than a mere reincarnation of another entity that did not qualify for 501(c)(3) status. Organizations applying more than 27 months after the end of the month in which the organization was formed (thereby missing the general deadline for fully retroactive 501(c)(3) status) are required to submit an additional schedule, and are given the opportunity to request Section 501(c)(4) status for periods prior to the application postmark date.<sup>28</sup>

The draft instructions to the proposed Form 1023-EZ generally restrict the eligibility of successors to for-profit entities and previously revoked organizations (and successors to such organizations) to use the Form 1023-EZ. However, organizations that were automatically revoked for failure to file Forms 990 could apply using Form 1023-EZ.<sup>29</sup>

The draft Form 1023-EZ provides two options for these “auto-revoked” organizations. Small organizations (i.e. those eligible to file Forms 990-EZ or 990-N for each of the three consecutive years they failed to file) applying within 15 months of revocation could seek retroactive reinstatement of Section 501(c)(3) status by checking a box attesting that (1) the applicant meets the specified requirements under section 4 of Rev. Proc. 2014-11, 2014-3 IRB 411, (2) the failure was not intentional, and (3) improved procedures have been instituted.<sup>30</sup>

<sup>21</sup> Draft Form 1023-EZ, Part III, Line 8.

<sup>22</sup> Form 1023, Part VIII, Lines 1 and 2.

<sup>23</sup> *Id.*

<sup>24</sup> Draft Form 1023-EZ, Part III, Line 3.

<sup>25</sup> Draft Form 1023-EZ, Part III, Line 4.

<sup>26</sup> Form 1023, Part VII, Line 1.

<sup>27</sup> Form 1023, Schedule G.

<sup>28</sup> Form 1023, Schedule E.

<sup>29</sup> Draft Form 1023-EZ, Part V.

<sup>30</sup> *Id.*

<sup>31</sup> *Id.*

<sup>32</sup> Rev. Proc. 2014-11, 2014-3 IRB 411.

<sup>33</sup> Form 1023, Part VIII.

<sup>34</sup> Form 1023, Schedule A.

<sup>35</sup> Form 1023, Schedule B.

<sup>36</sup> Form 1023, Schedule C.

<sup>37</sup> Form 1023, Schedule D.

<sup>38</sup> Form 1023, Schedule F.

<sup>39</sup> Form 1023, Schedule H.

<sup>40</sup> Draft Form 1023-EZ, Part III, Line 11.

<sup>41</sup> Draft Form 1023-EZ, Part III, Line 7.

<sup>42</sup> Form 1023, Part IX, A and B.

<sup>43</sup> *Id.*

<sup>44</sup> Reg. 1.170A-9(f)(4)(v), Reg. 1.509(a)-3(d).

<sup>45</sup> *Id.*

<sup>46</sup> Draft Form 1023-EZ, Part IV, Line 1.

<sup>47</sup> “IRS to Roll Out Form 1023-EZ in Summer, Anticipates Little Risk of Noncompliance,” *supra* note 3.

<sup>48</sup> Comment Letter by the National Council of Nonprofits, 4/30/14 (“By abdicating its front-end review of tax-exempt eligibility, the IRS is also shifting part of its enforcement duties and costs to state charity officials, who now rely on the IRS’ known-to-be-tough scrutiny in the tax-exempt determinations process. The abdication of the IRS’ scrutiny could lead to problems in the field, adding to the potential distrust of charitable nonprofits and the IRS’ determination process.”). See [www.councilofnonprofits.org/files/downloads/1023%20EZ%20Comments%20-%20National%20Council%20of%20Nonprofits.pdf](http://www.councilofnonprofits.org/files/downloads/1023%20EZ%20Comments%20-%20National%20Council%20of%20Nonprofits.pdf).

All other organizations may seek reinstatement of 501(c)(3) status as of the application postmark date.<sup>31</sup> Note that larger organizations or organizations missing the 15-month deadline may still be eligible for retroactive reinstatement of Section 501(c)(3) status under Rev. Proc. 2014-11, but it appears that applicants seeking this relief must apply using the standard Form 1023.<sup>32</sup>

The draft instructions to proposed Form 1023-EZ provide that applicants applying more than 27 months after the organization's formation will receive exempt status effective as of the application postmark date. To apply for Section 501(c)(4) status for prior periods, or otherwise make the case for an earlier effective date, applicants must either file a separate Form 8940 ("Request for Miscellaneous Determination") or apply using the standard Form 1023.

**Certain activities raising unique issues.** Part VIII of the Form 1023 asks questions regarding certain activities raising unique issues, including fundraising activities, donor-advised funds, economic development activities, joint ventures with non-501(c)(3) organizations, activities in foreign countries, cooperative hospital service organizations, cooperative service organizations of operating educational organizations, and charitable risk pools.<sup>33</sup> Form 1023 also requires separate schedules with additional detailed questions for churches,<sup>34</sup> schools,<sup>35</sup> hospitals,<sup>36</sup> supporting organizations,<sup>37</sup> organizations providing low-income housing or homes for the elderly or handicapped,<sup>38</sup> and organizations providing educational loans or grants to individuals.<sup>39</sup>

The draft Form 1023-EZ generally would not delve deeply into these activities, other than to ask whether the applicant provides disaster relief<sup>40</sup> or grants or other assistance to individuals or organizations outside the United States.<sup>41</sup> It would restrict the eligibility of certain types of applicants to use Form 1023-EZ. Note, however, that the draft instructions do not currently restrict organizations providing low-income housing or homes for the elderly or handicapped, or organizations providing educational loans or grants to individuals, from using the Form 1023-EZ.

**Financial data.** Part IX of Form 1023 requires in-depth reporting of past and/or present financial data.<sup>42</sup> A detailed statement of revenue and expenses is required, as well as a balance sheet as of the most recently completed tax year, with itemized schedules required for certain items.<sup>43</sup>

The draft Form 1023-EZ would not ask for any financial data, other than requiring the applicant to attest that its revenue history and projections meets the eligibility requirements.

**Public charity status.** The Form 1023 has not yet been updated on the issue of public charity status. Part X of the form still reflects the "advance ruling" process that was abolished in 2008. Currently, an applicant that can reasonably be expected to satisfy one of the support tests for its first five years will be deemed to be a public charity for its first five years.<sup>44</sup> If the applicant fails to actually satisfy one of the support tests for these periods, it will be treated as a private foundation beginning in its sixth year.<sup>45</sup>

Draft Form 1023-EZ would prompt the applicant to check a box stating that it "normally" satisfies one of the relevant support tests, noting that "[p]ublic charity status is a more favorable tax status than private foundation status."<sup>46</sup> Neither the draft Form 1023-EZ nor the draft instructions explain what "normally" means, or that the public support tests are ongoing and must continually be satisfied to maintain public charity status.

### Criticism of the Draft Form 1023-EZ

It appears that the IRS is intent on moving forward with Form 1023-EZ despite nearly unanimous criticism and concern. Critics point to obvious enforcement difficulties. Since so little information would be required and the Form 1023-EZ would provide no method of verification, many applicants could be tempted to submit false applications or falsely attest that they are eligible to submit the Form 1023-EZ. While the IRS has stated that it will shift its attention from the application process to enforcement once applicants are operational,<sup>47</sup> critics question whether the IRS will be capable of following through on this promise of additional audits. The task would be especially difficult given the possibility that the Form 1023-EZ will lead to a dramatic increase in the number of applicants. Further, as the National Council of Nonprofits has noted, 501(c)(3) status typically has tax and regulatory consequences at the state level, so the Form 1023-EZ arguably shifts oversight duties inappropriately from the IRS onto state governments.<sup>48</sup>

More fundamentally, critics also worry that the Form 1023-EZ abandons the crucial educational role that the application process has traditionally served. The standard Form 1023 requires new organizations to give serious

thought to difficult concepts like the exempt purpose test, the commerciality doctrine, the private benefit and inurement rules, and other aspects of a properly structured organization with a board of directors that operates in accordance with the organization's public responsibilities. In the absence of this forced training period, many new organizations will be tempted to commence operations without knowledge of the rules. This is likely to contribute to future enforcement difficulties and may erode the culture of compliance throughout the non-profit community.

### **Conclusion**

The Form 1023-EZ represents a paradigm shift in the exempt organizations field. New organizations will have a strong incentive to proceed under the

Form 1023-EZ, rather than endure the long, arduous, and expensive process of the standard Form 1023. It seems likely that non-compliant organizations will proliferate, given the lack of training and accountability provided by the current draft of the Form 1023-EZ. It remains to be seen whether the IRS will be able to enforce compliance through increased audits.

Despite these concerns, the Form 1023-EZ is a preferable option for most qualifying organizations (at least in the short term), including honest organizations that have every intention of complying with the rules. Accordingly, new organizations projecting annual revenue of \$200,000 or less would be well advised to hold off on submitting a Form 1023 until the summer of 2014, when the status of the Form 1023-EZ becomes clearer. ■