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Draft of Simplified EO Application Presents Problems, Group Says.

Draft Form 1023-EZ, "Streamlined Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code," would decrease the quality of information the IRS needs to make informed decisions, according to Tim Delaney of the National Council of Nonprofits.

April 30, 2014

Office of Information and Regulatory Affairs
Office of Management and Budget
Attention: Desk Officer for Treasury
New Executive Office Building, Room 10235
Washington, DC 20503

Treasury PRA Clearance Officer
1750 Pennsylvania Avenue NW, Suite 8140
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- RE: TREASURY DEPARTMENT'S PROPOSAL TO RADICALLY ALTER THE PROCESS FOR OBTAINING TAX-EXEMPT STATUS VIA AN ALTERNATIVE FORM 1023-EZ APPLICATION FOR RECOGNITION OF EXEMPTION UNDER SECTION 501(c)(3) OF THE INTERNAL REVENUE CODE

Dear Office of Management and Budget Officials: The National Council of Nonprofits submits the following comments in response to the Treasury Department's Notice of Submission for OMB Review published in the Federal Register (79 FR 18124) on March 26, 2014. That Notice invited "comments regarding the burden estimate, or any other aspect of the information collection" associated with the Internal Revenue Service (IRS) proposal to radically alter the process for obtaining tax-exempt status by "introducing an 'EZ' version of the Form 1023 as an alternative in applying for recognition of exemption from federal income tax under section 501(c)(3)."

As explained below, we 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.

OMB should not approve the proposed Form 1023-EZ; instead, OMB should — consistent with the Paperwork Reduction Act — put the public’s interest in “accountability, transparency, and openness in Government and society” before the interest of simply reducing a backlog at the IRS, significant though it may be. See 44 U.S.C. § 3501. We agree with the IRS that the long-established Form 1023 and application process need review and streamlining. However, we are concerned that the proposed new EZ Form and related express-lane approval process go too far and too fast, representing radical departures from proven protocols. In response to the Treasury Notice seeking “suggestions for reducing the burden,” the IRS should meet first with other key stakeholders — including the public, existing charitable nonprofits, the funding community, and state charity regulators, such as occurred when the IRS redesigned the Form 990. Therefore, we are sending a copy of these Comments to the Commissioner of Tax Exempt and Government Entities and the Director of the IRS Exempt Organizations Division to alert them to our serious concerns and request that they withdraw the proposed new form and gather more input before radically changing the way applications for tax-exemption are evaluated by the IRS.

The Interests of the National Council of Nonprofits

The National Council of Nonprofits is a 501(c)(3) charitable nonprofit that serves as a trusted resource and advocate for America’s charitable nonprofits. Through our network of State Associations and 25,000-plus members — the nation’s largest network of charitable nonprofits — we serve as a central coordinator and mobilizer to help nonprofits achieve greater collective impact in local communities across the country. We identify emerging trends, share proven practices, and promote solutions that benefit charitable nonprofits and the communities they serve. Our core mission is “to advance the vital role, capacity, and voice of charitable nonprofit organizations through our state and national networks.” An IRS decision to grant status as a charitable nonprofit is a momentous one creating cascading results, so it should not be done lightly. Through operation of longstanding interdependent federal and state laws, many things happen once the IRS issues a determination letter recognizing an organization as being exempt from federal income tax under section 501(c)(3). For instance, in many states it activates exemptions from state income taxes and local property taxes. Also, it triggers eligibility for charitable nonprofits to receive donations that are deductible at the federal and usually state levels. In exchange for these and other benefits of being recognized as tax-exempt, charitable nonprofits and private foundations forfeit certain rights. For example, they are not allowed to support or oppose political candidates. Plus, they give up privacy rights afforded to others — they file federal tax information returns annually that are open to public inspection. And the list of inter-related federal, state, local, and private causes and effects/costs and benefits goes on.

The IRS’ proposed new Form 1023-EZ and related process for obtaining express-lane authority to solicit charitable deductions are radical departures from proven protocols that could have a profound impact on the foregoing inter-related balancing that involves the nonprofit community. To underscore the significance of what the proposed changes could mean, consider the following observations we have received from nonprofit leaders across the country in the last several days since learning about the Paperwork Reduction Act review (emphasis added):

- *I counsel new nonprofits weekly, and though I appreciate the IRS’s attempt at efficiency, I think **this could be disastrous**. I think that we need to look at the overall confidence this move could erode with the American public over time (based on potentially “legitimate” nonprofits seeking funding for causes that have not been thoroughly vetted). This wouldn’t happen immediately, but it **could be a bad legacy to leave for the next generation** of leadership, one that would be difficult to course correct once people became use to the ease of the process.*
- *The current process is slow but it requires effort and energy and pushes away those that are not*

prepared. At a minimum allows some thoughtfulness and energy in describing who you are and how you will operate. **To remove the requirement simply pushes the clean up to 3 years from now as the system falls apart and there is a backlash of onerous exams and audits.**

- **We don't need a proliferation of tax exempt organizations.** Already, cultivating and recruiting functional boards is a challenge. Funding is a challenge.
- Having gone through the application process with a museum I helped start, we were put through the ringer by the IRS which to some extent **forced us to think through our plans** (mission, vision, intent, how we would operate, etc.) ultimately, I believe, making us stronger.
- While I recognize the process in and of itself is not necessarily user friendly, it has supported a perception of the awesome responsibility to become tax exempt and serving the community. In making the process more streamlined it may only lessen the perception of **the "awesome" responsibility to the community that a group has** after being granted the tax status.
- While the idea of simplifying the application process for smaller organizations is laudable, **the proposed Form 1023 EZ goes way too far.** Although a charity is supposed to review the requirements in advance and attest to having the requisite purposes and documents, this proposal removes the crucial step of having someone independent (in this case, the IRS) to verify the existence of these documents or ensure that the required provisions are actually in place. **Although the IRS estimates that it will take 14 hours to fill out the new Form 1023 EZ, I could easily see many applicants spending as little as an hour or so — not because they deliberately intend to skirt the law, but because they simply don't know or understand what they are required to certify.** Sure, they may (or may not) have the documents, but do they even say the right things? We've encountered similar situations through our legal assistance program for startup organizations, simply because people often "don't know what they don't know" without a legal review or a competent IRS agent. Clearly, **without these safeguards in place, the door could be opened for improper approval of thousands of applications each year.**
- Generally, Form 1023 is not very accessible, too long, and quite cumbersome. The form should be simplified, **but this EZ form does this too much.** There some useful exercises that are part of the 1023 filing process that are useful in setting up a sustainable organization (bylaws, business/revenue plan, conflict of interest policies, the programs narrative). The full 1023 is overwhelming and is discouraging to some, but **also a deterrent to those with only half-baked plans and ideas.** I understand that the IRS wants to clear the backlog, but this may not be the best solution as it is in its current draft format. If the 1023 EZ was improved in some ways, it might be a good option.
- **This change could wreak added havoc for regulators,** since the rigorous review of EO applications will not have been done beforehand, opening the door for all kinds of problems in terms of non-compliance (again, intentional or otherwise) and enforcement issues for both state and federal regulators. In terms of wise utilization of IRS resources, **this may actually cost more in the long run, and could seriously undermine public trust in the sector if problems end up increasing as a result.**

Before such a potentially significant change is implemented, it merits far greater public input than just a limited Paperwork Reduction Act review. The IRS should seek the views of not only existing charitable nonprofits (many of which, in hindsight, recognize the value of slowing down to complete the Form 1023), donors and foundations (many of whom — because they already question whether there are too many nonprofits — may want to be heard on the subject of possible proliferation), researchers (who may express concern that a valuable source of information — all parts of the Form 1023 application, plus accompanying documentation — will no longer be available to them), and state charity regulators (whom we understand will be filling separate comments to detail their concerns and reiterate their position in 2012 when they "uniformly oppose[d] a Form 1023-EZ"¹).

Background

During the last several years, the IRS has accumulated a backlog of pending applications for tax-exempt status.² According to an internal IRS memorandum dated February 28, 2014, IRS managers have been analyzing how to streamline its processes. That memorandum suggests that the only goals considered in connection with the proposed streamlined process were to reduce (a) the IRS backlog of filings and (b) the informational burden for the applicants. Both are laudable goals. However, focusing on those two exclusively ignored multiple other perspectives and significantly sidestepped the IRS' obligation to base a determination about tax-exempt status on solid information rather than a mere certification. This excerpt from the memo suggests the IRS focused on its own internal management issues rather than any consideration of the possible external consequences that its proposed radical changes might create:

The assessment concluded that the current process has high inventory, limited resources, inaccurate forms, outdated IRMs, continuously changing procedures, multiple touch points, multiple work streams, and non-standard processes. In addition, inadequate technical tax law training has not equipped the workforce to effectively/ efficiently complete the work.

The memorandum also reveals that the IRS has been working on this issue internally since at least June 2013. However, neither the memo nor a review of the IRS website shows any indication that the IRS invited the public or affected stakeholders to provide their informed perspectives, until Treasury filed its narrow Paperwork Reduction Act Notice in the Federal Register on March 31, 2014. That is most unfortunate, because the proposed Form 1023-EZ is a radical departure from the more meaningful review that multiple stakeholders have relied on the IRS to conduct with profound care. The Notice published in the Federal Register on March 31, 2014 asking for comments on the new form by April 30, 2014 may suffer from a fatal procedural flaw. The Notice referenced a draft Form 1023-EZ that was two pages in length, dated February 19, 2014 (labeled "Version A, Cycle 4"). Yet almost a month later, the IRS disclosed a possible substitute two-and-a-half page draft Form 1023-EZ, dated April 23 (labeled "Version A, Cycle 12"). It appears that Treasury gave OMB and thereby the public one version of the Form 1023-EZ, but the IRS has revised the form during the comment period without resubmitting it for approval. The two forms, while carrying the same title and similar in many respects, contain material differences. The subsequent version expressly allows use by organizations seeking two alternatives for reinstatement after automatic revocation, while the first version does not provide them. If the Paperwork Reduction Act process is to be meaningful, then the document being submitted for public comment and OMB approval should not be a moving target. At a bare minimum, OMB, rather than approve the Form 1023-EZ that the Treasury submitted for public comment on March 26, should require Treasury to resubmit.

I. The Proposed EZ Form and Express-Lane Approval Process Will Decrease, Rather Than Improve, the Quality of Information the IRS Needs to Make Informed Decisions

To ensure that organizations are properly qualified and prepared to earn tax exempt status and thus eligible to receive deductible contributions, the IRS has required organizations seeking tax-exempt status under section 501(c)(3) to apply for that benefit. For decades, the IRS has used Form 1023 for groups seeking exemption under section 501(c)(3) (public charities and private foundations). The Form 1023 requires organizations to think through the fiduciary and governance responsibilities of the board of directors as well as identify what the organization will achieve, and how it will be funded. Typically, during a regular review of exemption applications, IRS employees ask questions and require submissions that ensure that start-up groups have at least a passing understanding of such concepts as not furthering non-exempt purposes and private inurement. Unless that sort of verification process is ensured in the streamlined process, there is a risk that recognition for tax-exemptions will be handed to applicants that fail to meet statutory requirements or do not have a threshold understanding of what tax-exempt status requires of their activities and operations. The streamlined procedures only require that a filing organization "certify" compliance (as opposed to the IRS verifying compliance). As enumerated below, in our opinion the 1023-EZ streamlined

approval process does not give the IRS enough quality information to determine eligibility for federal tax-exemption. Moreover, there are a few vague questions in the proposed form that may prove problematic for applicants.

The proposed Form 1023-EZ (looking at the official February 19, Version A, Cycle 4):

- 1. Has no requirement that the applicant demonstrate it has adopted bylaws.
- 2. Part II, Lines 5, 6, and 7: Unless the instructions are very detailed, easily understandable, and specific, many applicants will need guidance in order to understand the organizational test and to complete the certifications accurately on a truly informed basis.
- 3. Part III, Line 2: Rather than asking the applicant to describe what its purposes are (which requires the IRS to have trained examiners to discern whether the description meets the operational test), the Form 1023-EZ invites applicants to “check all that apply” and offers eight categories that may prove confusing to applicants since their perceptions of their own organizations may not fit into those pre-selected legal categories.
- 4. Part III, lines 4-11: These questions require a “yes” or “no” answer. Many of these questions ask about activities that could go over the line into impermissible conduct by a 501(c)(3) organization, but may also be permissible, depending on the circumstances. If the IRS intends to use the responses to these “yes” or “no” questions to deny tax-exempt status, without probing further into the expected activities of the applicant on, that would be inappropriate and harmful to those attempting to establish legitimate tax-exempt public charities but who misunderstand the concepts or have language differences. Consequently, including these questions on the form requires an investigation of the responses, which therefore must be reflected in the protocol /procedures for the examining IRS agent.
- 5. Part IV, under the heading: “Part IV is designed to classify you as an organization that is either a private foundation or a public charity. *Public charity status is a more favorable tax status than private foundation status.*”(Emphasis added.) It seems curious for the IRS, as the regulating entity responsible for evaluating eligibility for tax-exemption, to be advising the filing organization as to the more advantageous tax status.
- 6. Part IV, Line 1: These three sub-questions require a level of understanding of the federal Tax Code and public support test that we submit most of the applicant using the 1023-EZ will not have. Consequently, these questions are likely to lead to errors by the applicants which will only lead to increased burdens, both on the IRS (unless it has a smooth efficient process planned to educate filing organizations) and the applicants down the road that may inaccurately complete the form, only to have their applications rejected.
- 7. Unlike in Part V of the existing Form 1023, the proposed Form 1023-EZ does not ask sufficient questions about the family relationships of board members or the business relationships between the applicant and its board members for the IRS to determine whether there is a risk of private inurement or private benefit.
- 8. The current Form 1023 application process asks the applicant to submit its organizing documents, which then become part of the public record. With the streamlined process, organizing documents will not be required if the applicant uses the certification option. This reduces the amount of data available to researchers and the public about the charitable nonprofit community (and creates a disconnect with the Form 990, which asks filing organizations to submit updates/amendments to their organizing documents).

9. Pointedly, there is no question on the proposed Form 1023-EZ asking whether the filing organization has a conflict of interest policy, which is a fundamental governance document for any tax-exempt organization and should be part of the scrutiny given by the IRS at this critical juncture in evaluating eligibility for tax-exemption. The existing full Form 1023 does.

10. There should be more guidance in the instructions about the annual filing requirement — including the thresholds for which version of the Form 990 should be filed.

We support efficiency and reducing burdens to applicants, but not at the expense of accountability. In filing these comments we find ourselves in an ironic position. In most instances, the National Council of Nonprofits would applaud efforts to simplify and streamline government forms and processes. *See, e.g.,* our statement commending OMB for its work streamlining the government grant process and our Streamlining Reports, such as *Partnering for Impact: Government-Nonprofit Contracting Task Forces Produce Results for Taxpayers*. Yet here, in looking at the full picture over the long-term, we are concerned that the advantages of a rapid-fire approval process will not outweigh (a) the risks and ramifications of recognizing groups as tax-exempt that may not be prepared to meet ongoing exempt organization requirements, or (b) the risk of not recognizing eligible groups that make errors completing the Form 1023-EZ due to lack of guidance by the IRS in a streamlined process.

II. Concerns That the Proposed New Form and Related Express-Lane Approval Process Will Reduce Public Trust

We *expressly* and *emphatically* reject any notion that smaller organizations are more likely to evade the law or commit errors, purposefully or otherwise. Smaller does not equate to incompetent or fraudulent. Yet if the IRS significantly lowers the bar for recognition for applicants claiming to be smaller, then it stands to reason that bad actors will seek to exploit this weakness in the overall application system and opt to use the EZ express-lane approval process to avoid the transparency mandate that is integral to the current Form 1023 application process. When *fraudulent* disguises itself in this situation, everyone suffers. Thus, we are concerned that the proposed radical diminishment of information available to the IRS to make informed determinations about Section 501(c)(3) status will erode public trust in charitable nonprofits. For individual charitable nonprofits, earning the public's trust starts with the application for tax-exemption.³ Federal law has long required each charitable nonprofit to make its organization's application for tax-exemption, *including all supporting documents* and related correspondence, freely available for public inspection. Reducing the Form 1023-EZ to a simple check-off form renders the mandate of transparency to public scrutiny a rather empty and meaningless exercise.

The IRS has an obligation to ensure that organizations are properly qualified as tax exempt and thus eligible to receive deductible contributions. Completing the Form 1023 requires organizations to think through and identify their anticipated sources of revenue and planned activities, as well as demonstrate that the filing organization is organized in accordance with the Internal Revenue Code's requirements for public charity or private foundation status. Typically the process of completing the application is time-consuming, often due to back-and-forth communications between the IRS and the filing organization, all of which are subject to public disclosure. In fact, those communications provide a window of transparency for the public into the process by which applicants are evaluated and recognized by the IRS as tax-exempt. In contrast, with the streamlined process of merely asking filing organizations to certify to the existence of various provisions in their organizing documents, the transparency that the public has come to expect (the ability to view organizing documents and understand why tax-exemption was either recognized or denied) will be eliminated.

III. The IRS Is Inappropriately Shifting Its Duties onto Others — Foisting Burdens on the Public, Existing Charitable Nonprofits, and State Charity Regulators

The IRS recognizes that it is stepping back from its front-end enforcement work in favor of having a

“robust compliance process at the back end.”⁴ Yet, as noted above, a complex interdependent system relies on the IRS to perform its vital front-end duties. Furthermore, as the IRS continues to be underfunded and understaffed to conduct current compliance tasks, it should not rely on expanding back end enforcement as a remedy for lowering the initial barrier to entry. By abandoning aspects of its initial screening role, the IRS is passing its responsibilities onto others, creating new burdens for them. That is fundamentally unfair, especially when the IRS has not conducted a full risk assessment with other partners in the complex system that rely on the IRS to do its duty. Increases Potential Burdens to Taxpayers

By abdicating important aspects of its front-end review of tax-exempt eligibility, the IRS is shifting burdens to others, including the public, which will potentially be faced with more expensive back end enforcement actions for groups that received fast-track tax-exemption, but are not following the procedures expected of tax-exempt organizations. The IRS has indicated that it does not have enough auditors to do needed back end enforcement work, so this effort to create an expedited process to solve an immediate backlog problem may only exacerbate problems at the back end, creating more costs for taxpayers to clean things up when things go awry.

Increases Burdens for Existing Nonprofits

As mentioned earlier, each charitable nonprofit relies on the public’s trust in order to continue to attract resources to advance its mission. The proposed easy-application/easy-approval process portends damaging the public trust that legitimate charitable nonprofits earned and need to operate in local communities across America. When negative stories get published about nonprofits (even non-charitable nonprofits, such as social welfare organizations), it hurts all nonprofits, making it more difficult to recruit board members, volunteers, and obtain donations to advance charitable missions.

Increases Burdens to State Governments

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.

IV. The Proposed EZ Form and Approval Overlook the Value of the Full Form 1023

As the IRS ACT report, “Exempt Organizations: Form 1023 — Updating It for the Future,” observed:

- The primary reason we do not recommend the development of a Form 1023-EZ is because Form 1023 serves an important educational purpose for applying organizations. Through its questions, the form forces the applying organization to think somewhat deeply about its activities, finances, and management. The form also signals to the organization that it is entering into a (probably unfamiliar) comprehensive regulatory regime, and working through the questions on the form provides the organization with a great deal of information about compliance with this regime. We agree with the many practitioners we spoke with who believe that the educational benefits of Form 1023 are especially important for small organizations. And we do not believe that a significantly shorter Form 1023 could provide a comparable level of these benefits.

Our concern is that rather than help smaller groups start out on the right foot, the fast-track approval process will loosen the threshold requirements that currently ensure a thoughtful process that makes a newly-forming exempt organization aware of its initial and ongoing obligations. Without a significant effort by the IRS to educate newly formed groups about the obligations of tax-exemption, filing out the proposed Form 1023 EZ will be just as confusing, and perhaps more

confusing because of the lack of explanation, than the existing Form 1023. Since by definition the streamlined process will result in the IRS spending less time reviewing the applications, we are equally concerned about applicants using the proposed Form 1023 EZ only to have their applications denied — when in other circumstances a more thorough review would have resulted in recognition of tax-exempt status.

* * *

As a network that assists individuals who are in the process of creating charitable nonprofits, we agree that the existing Form 1023 and associated approval process need to be improved. But we reject a perspective that puts more weight on a short-term myopic perspective of what's easiest for the IRS today, rather than on a process that over the long-term serves and supports everyone — applicants, charitable nonprofits, funders, state charity regulators, and the public.

V. Recommendations

The National Council of Nonprofits calls on the OMB to not approve the Form 1023 EZ. We also urge the Treasury Department and IRS to:

- 1. Withdraw the proposed Form 1023-EZ and streamlined determinations process;
- 2. Continue the reform effort because the old Form 1023 and application review process need updating, but do so only with guidance from the public, the charitable nonprofit community and its stakeholders, so the appropriate balance can be struck between increasing efficiency, minimizing the burden on the filing organization and the IRS, and enhancing public trust.

- Respectfully submitted,
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FOOTNOTES

¹ See IRS Advisory Committee on Tax Exempt and Government Entities (IRS ACT), "Exempt Organizations: Form 1023 — Updating It for the Future," in Report of Recommendations (June 6, 2012) at 32 of Exempt Organizations report (page 104 of PDF) (emphasis added).² We recognize that some of the backlog may be due to reduced funding, forcing the IRS workforce to be reduced by about 10 percent since 2010. See Prepared Remarks of Commissioner of Internal Revenue Service

John Koskinen before the National Press Club, April 2, 2014. That backlog may have grown when more than 250 IRS employees were diverted to comply with information requests by six investigations dealing with the Exempt Organizations Division that oversees the applications for both 501(c)(3) charitable nonprofits and the 501(c)(4) social welfare organizations that has generated so much negative publicity in the last year.

³ The National Council of Nonprofits' Public Policy Agenda notes, among other things: "The nonprofit community recognizes that mission-driven nonprofits can be successful only by earning and maintaining public trust through appropriate transparency, which can be guided by reasonable regulation that recognizes the unique role of these organizations in communities."

⁴ "A new streamlined process for the Form 1023-EZ . . . will also allow the IRS to concentrate more on compliance for Section 501(c)(3) organizations at the back end." See Diane Freda, "IRS to Roll Out Form 1023-EZ in Summer, Anticipates Little Risk of Noncompliance," Bloomberg BNA (April 25, 2014) (media call with Sunita Lough, IRS