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New IRS Form May Fuel Nonprofit Political Activity.

When it comes to political campaign activity and section 501(c)(3) compliance issues, what was old may become new again, thanks to a new IRS exemption application form, several experts told Tax Analysts recently.

The IRS has rolled out Form 1023-EZ, "Streamlined Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code" 2014 TNT 127-51: Forms Watch. The form's instructions 2014 TNT 76-41: Forms Watch remind applicants that 501(c)(3) groups cannot directly or indirectly participate or intervene in any campaign at the federal, state, or local level on behalf of, or in opposition to, any candidate. But critics have said the streamlined form creates major compliance risks, effectively greenlighting potential 501(c)(3) organizations with minimal inquiry into their activities.

IRS Commissioner John Koskinen has defended the form, telling Tax Analysts in a July interview that the simpler, electronic form will allow the agency to more effectively use its resources.

The trouble is, the form is a checklist and not a "true application," said Arthur Rieman of the Law Firm for Non-Profits. The form, he said, allows organizations to claim exempt status using "the honor system." The nearly automatic exemption that Form 1023-EZ filers can get will allow those wishing to game the system to use their 501(c)(3) approval to do whatever they want, until they shut down the organization or the IRS catches them, he said.

Section 501(c)(4) social welfare organizations play a significant role in campaigns now. But thanks to the new IRS form, charities will be the next wave of politically active exempt organizations, said Marcus Owens of Caplin & Drysdale during a panel discussion in Washington in early July.

There won't be any IRS inquiry into the planned activities of an organization filing the Form 1023-EZ, and the IRS's ability to audit those groups is constrained, said Owens, who formerly served as EO director in the IRS Tax-Exempt and Government Entities Division.

"The IRS conducts audits of somewhere around 2,500 to 3,000 tax-exempt organizations a year — there are one and a half million of them," Owens said. "So your chances, once you have tax-exempt status, of losing that status in an audit are virtually nil unless you tie yourself to the door of the IRS building and proclaim you're going to violate the tax law."

Prior Political Involvement

The political use of nonprofit organizations started with the use of 501(c)(3) groups in the 1990s to push the bounds of issue advocacy, said University of Miami law professor Frances Hill. If there are political operatives who decide it's time to again use 501(c)(3) organizations for "muscular issue advocacy" as part of an electoral strategy, they can find a way to make it happen, she said. "This is all a matter of tactical planning," Hill said. "We started out with [former Rep.] Newt Gingrich and his 501(c)(3)s, a cluster of them. I think we may be returning to that."

In 2003 the IRS restored section 501(c)(3) status to a pair of groups with ties to Gingrich — the Howard H. Callaway Foundation and the Abraham Lincoln Opportunity Foundation. The Callaway Foundation made grants to the Lincoln Foundation, whose attorney said the group was formed to allow Republicans to support charitable causes in the Denver area. Gingrich had been accused of improperly using charitable funds for political purposes.

Political campaigns have since transformed, and the most effective messaging now focuses on issues rather than candidates, Owens said. After the Supreme Court's decision in Citizens United v. FEC, 558 U.S. 310 (2010), he said, campaigns are increasingly following a structure pioneered by former Sen. Jesse Helms, who had a network of organizations working for him, including a charity that prospected for donors.

The new streamlined 501(c)(3) application paves the way for that trend to continue, Owens said. "A modern political campaign is really now a collection of different organizations," he said, adding, "A (c)(4) could, for example, talk about the various candidate positions but in a way that doesn't necessarily suggest one over the other so that it has a nonpartisan feel to it. The expedited processing procedure will make it easy to create . . . a swarm of (c)(3)s, all relatively small but very targeted in their educational efforts."

Section 501(c)(3) status allows an organization both to offer its donors the charitable contribution deduction and to create "a halo" around the message it is advocating, Owens said.

"Talking about issues like the environment, for example, or for that matter Second Amendment kinds of rights, is easily cast as an educational activity under section 501(c)(3)," he said, adding that such messaging is likely to have "a higher credibility with the viewer or the listener than a more overt political message or the same message coming from an acknowledged political source."

Pop-Up Charities and Other Fears

State and federal regulators alike may have a hard time tracking down some politically active 501(c)(3) groups. An organization can be exempt under state law and not under federal law, Hill said, adding that some states permit various types of nonprofit organizations to engage in considerably more political campaign activity. Even if some organizations ultimately lose their federal exemptions, they might keep their state tax-exempt status, she said.

Owens said that if, as he fears, a swarm of ostensibly educational but truly political 501(c)(3)s develops close to an election, those groups will likely have a lifespan of less than a year. And if they never file a Form 990, all the IRS will have to use in tracking them down is the Form 1023-EZ.

"It won't contain much information," Owens said. "It may contain an address that is a post office box somewhere."

The potential emergence of these pop-up organizations is the concern regarding the new form, Hill said. There are no safeguards against political activity in the new application process, she said, though she added that the long form exemption application for charities doesn't prevent substantial campaign activity anyway.

State regulators don't have the resources, either, to deal with pop-up organizations that disappear before anyone has learned of them, said Douglas M. Mancino of Hunton & Williams LLP. He said he shares concerns about the potential for abusive pop-up charities, political or otherwise, to launch using the streamlined application.

Mancino said that he's interested in seeing what kind of statistical sampling the IRS comes up with

to review the activities of organizations that file the streamlined form, but that developing that sampling takes time. And a lot can happen before that work is done, he said.

“Frankly, armed with a determination letter, you really can go out and do a lot of damage to the sector,” Mancino said.

When the IRS released the final form on July 1, Benjamin Takis of Tax-Exempt Solutions PLLC said that unless the IRS can hold organizations accountable for inaccurate financial projections or misrepresenting their purpose or activities, there is a substantial risk of fraud and noncompliance.

Takis later expanded on those concerns, saying, “There is certainly a lot of gray area in the definition of political activity for organizations that are looking to game the system, and the Form 1023-EZ will only make it harder for the IRS to combat these tactics.”

On the state-level regulation issue, Takis said, “I don’t know of any legal obligation for the IRS to design forms and policies in a way that eases the burden on states, but the Form 1023-EZ certainly disrupts the balance that has developed between federal and state oversight of charities, and the effects of this disruption could be profound.”

State charity regulators aren’t exactly welcoming the new IRS form. In an April 30 letter 2014 TNT 144-77: IRS Tax Correspondence to the IRS, the National Association of State Charity Officials condemned the streamlined form, saying it would pave the way for fraud and increase the burden on state regulators, whose enforcement capabilities are already stretched thin.

Given the comments the state charity officials group submitted, it appears state regulators will treat use of the Form 1023-EZ as a red flag, Mancino and a colleague, Ofer Lion, wrote in a client alert posted on their firm’s website. Mancino and Lion also wrote that early returns suggest that Form 1023-EZ filers are receiving determination letters within three weeks.

IRS Defends the Form

Up to 70 percent of all organizations applying for 501(c)(3) status will be eligible to file the streamlined form, the IRS said in a statement. Organizations are instructed that they must not substantially engage in activities that contradict their exempt purpose, and the agency said it will ramp up its education and outreach work to organizations eligible to file the Form 1023-EZ.

In a July 1 memo 2014 TNT 129-52: Other IRS Documents providing interim guidance on the form, Matthew Weir, IRS director of EO rulings and agreements, said IRS examiners will review submitted Forms 1023-EZ in order of submission, while ensuring all fields on the form are complete. Using a sampling plan, determinations specialists will perform a predetermination review on randomly selected cases before issuing a determination letter, the memo says.

Koskinen told Tax Analysts that this new exemption application process will allow smaller organizations to obtain approval while avoiding the same scrutiny given to larger organizations, without the IRS sacrificing its improved monitoring of all organizations. “The net result is that there will be less risk to the public,” he said.

Applicants will file the new Form 1023-EZ electronically, which will allow the agency to more easily screen applications with inconsistent answers or ones that raise questions before it issues approvals, Koskinen said. The agency will also test the accuracy of the short form by taking a statistical sampling of streamlined applications and subjecting them to the more rigorous, full exemption application, he said. The IRS will do still another sampling of Form 1023-EZ applicants a year after they’re approved and audit “how they’re doing and what they are doing,” Koskinen said.

“We’ll be better at the front end, but we’ll have more resources available to check on people at the back end and see are you doing what you said you were going to do,” Koskinen said. “Are you still doing the right thing? Now we’ll know.”

Takis interpreted the situation differently. “One challenge for the IRS will be that the Form 1023-EZ is likely to lead to many more organizations getting formed and applying for 501(c)(3) status, so it’s going to be that much harder for the IRS to keep track of all these organizations and find the bad actors,” he said.

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