



Form 1023-EZ Is Too Easy

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Fifty-five percent of organizations applying for 501(c)(3) status in fiscal year 2015 applied using the new Form 1023-EZ. But the National Taxpayer Advocate, part of the Taxpayer Advocate Service (TAS), recently released a [report](#) to Congress indicating that the new form appears to have significant problems and that the Internal Revenue Service (IRS) went too far in reducing the amount of information required from a tax-exempt applicant. The statistics are even more daunting when one compares the number of 501(c)(3) applications in FY 2014 (100,032) to the number in FY 2013 (45,289).

The TAS is an independent organization within the IRS that helps taxpayers and protects taxpayer rights. The Taxpayer Advocate is appointed by and reports to the Commissioner of Internal Revenue and is responsible for identifying problems and proposing changes in the administrative practices of the IRS.

The new Form 1023-EZ was introduced in July 2014 to provide a simplified method for small organizations to apply for tax-exempt status as a section 501(c)(3) organization. While the Taxpayer Advocate had initially also recommended a simplified form for small organizations, it ultimately expressed concern that the new form lacks requirements that would prove whether an organization is eligible for tax exemption.

The Tax Advocate may have recommended a simplified form because of the severe backlog of applications for tax exemption that the IRS and the public were experiencing. At the time, thousands of organizations were reapplying for tax-exempt status after they failed to file Form 990 for three consecutive years and had their status revoked. As a result of the backlog, the applications were taking 18 months or more to be assigned to a reviewer, and nonprofits were waiting months or years for determinations from the IRS.

Initially, the new form was appealing as most small organizations (with gross receipts of \$50,000 or less and assets of \$250,000 or less) seemed to qualify and it significantly reduced the number of applicants using the full-blown process by implementing a digital solution. However, there has been some debate about whether this solution was the correct one.

Passing (or Failing) the Organizational Test

Organizations seeking tax exemption under Internal Revenue Code (IRC) section 501(c)(3) must pass organizational and operational tests. The organizational test requires that certain provisions be in the organizing documents (articles of incorporation and bylaws) that show the entity is organized for exclusively 501(c)(3) purposes (purposes clause) and that assets are dedicated in perpetuity to charitable purposes (the dissolution clause). Failing the organizational test means that the entity does not qualify as a charity.

The Taxpayer Advocate's study examined 408 organizations that had applied for section 501(c)(3) status using the shortened Form and found that 37 percent failed the organizational test because their articles of incorporation did not have an appropriate purposes clause or dissolution clause or had neither. The study was based on a review of organizations from states where the articles of incorporation could be found online. The report states, "It took the reviewers about three minutes on average to review an organization's articles and determine whether there were acceptable purpose and dissolution clauses."

Key Differences between the Forms

The organizational test is just one example of where the 1023-EZ may have gone too far in the direction of efficiency. While the full Form 1023 with additional schedules and attachments is 12 pages long, the 1023-EZ is only two pages. Aside from the length, the 1023-EZ differs from the full Form 1023 in three significant ways:

- Articles of Incorporation and Bylaws are not required to be submitted.



- The applicant does not have to provide a narrative description of its activities.
- Only an attestation is required regarding private inurement or private benefit – not information such as financial details.

Newly formed organizations can use the simplified form as can some organizations that have had their exempt status revoked for failure to file a Form 990 for three consecutive years. However, not every organization is eligible to use the two-page Form 1023-EZ. The organization cannot have more than \$250,000 in assets, nor can it have more than \$50,000 of income for the past three years or project more than \$50,000 for the next three years. Many organizations that qualify to file the Form 1023-EZ would also qualify to file the Form 990-N postcard, whereby an organization must attest that it normally has no more than \$50,000 in gross receipts. Some of the other organizations that would not qualify to file the Form 1023-EZ include churches, schools, hospitals and supporting organizations. The [instructions to Form 1023-EZ](#) include an eligibility worksheet with 26 questions, wherein if any of them are answered “yes”, it will cause the organization to be ineligible to use the Form 1023-EZ.

Doubts Remain about Organizations’ Charitable Activities

In addition to deficient articles of incorporation, the study found that only about half of the organizations surveyed had websites that would allow the IRS to easily find information about the activities of the organizations. The study found eight organizations in the sample that had previously filed tax returns as taxable corporations and questioned whether those organizations had changed their operations to be charitable.

Because section 501(c)(3) organizations can receive tax deductible contributions, these organizations are, in essence, subsidized by public funds. Therefore, it is imperative that only organizations that deserve section 501(c)(3) status are granted such status.

The Taxpayer Advocate has provided the IRS Exempt Organizations division with the names of the organizations that failed the tests. The Taxpayer Advocate recommended that the Form 1023-EZ be modified to require applicants to submit organizing documents, a narrative description of activities and financial information.

Although it appears that the IRS may still not require the articles of incorporation, it appears that it is taking steps to limit the risk of ineligible organizations being granted such status—steps such as pre-determination reviews, educational materials and clarifying instructions.

Conclusion

The IRS is taking many steps to make the exemption application process more efficient. In addition to the Form 1023-EZ, the IRS is employing additional requests for information during the regular application process to weed out ineligible applicants. If applicants do not provide the required information in a timely manner, the case will be closed and the applicant will have to re-file with a new user fee. Also, when the IRS now receives an application that is incomplete (for example, it does not have the proper signatures, taxpayer identification numbers, a narrative or other required information), [it will be returned](#) to the applicant with the applicable user fee, and applicants can decide whether they want to re-submit.

Facing limited resources, the IRS is attempting to be more efficient. The Form 1023-EZ was an attempt to increase efficiency and it appears that the IRS is starting to take additional steps to insure that small organizations meet the basic requirements.

Tax exemption is a privilege and not a right. Especially in the case of 501(c)(3) organizations where taxpayers can make deductible contributions, a lack of close monitoring leaves opportunities for abuse. The IRS’ first bite at the apple of compliance is to test the organization before it grants the organization exemption. The Form 1023-EZ may be appropriate in situations in which the IRS had already previously vetted the organization with the full Form 1023 but revoked exempt status because Form 990 was not filed for three years. In that scenario, the IRS would already have important information and documents about the organization. However, in other situations, it appears that more information is needed so that the exempt organization community and the public are protected. For now, it appears that the IRS will keep the online application, but it will be taking additional steps to see if these organizations actually do qualify for exemption.