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## ESSAY

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### FORM 1023-EZ AND THE STREAMLINED PROCESS FOR THE FEDERAL INCOME TAX EXEMPTION: IS THE IRS SLASHING RED TAPE OR OPENING PANDORA'S BOX?

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#### INTRODUCTION

On July 1, 2014, the Internal Revenue Service (IRS) released Form 1023-EZ, a streamlined version of the application required of all organizations seeking federal tax-exempt status under section 501(c) of the Internal Revenue Code.<sup>1</sup> By stripping away familiar elements like the narrative of specific activities, financial projections, and provision of organizing documents, Form 1023-EZ requires dramatically less time to complete<sup>2</sup> and represents a radical change to a decades-old process.<sup>3</sup> It is expected that approximately seventy percent of the 80,000 organizations annually applying for tax-exempt

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<sup>1</sup> I.R.C. § 501(c) (2012).

<sup>2</sup> According to the IRS, Form 1023-EZ requires approximately nineteen hours to complete. See INTERNAL REVENUE SERV., INSTRUCTIONS FOR FORM 1023-EZ, at 10 (2014) [hereinafter FORM 1023-EZ INSTRUCTIONS] (including time estimates for recordkeeping, learning about the law or the form, preparing the form, and submitting the form to the IRS). In contrast, the current version of Form 1023 is estimated to take 105 hours to complete, even when omitting the time needed to submit any required schedules. See INTERNAL REVENUE SERV., INSTRUCTIONS FOR FORM 1023, at 24 (2006) [hereinafter FORM 1023 INSTRUCTIONS] (listing time estimates for completing Parts I to XI of Form 1023).

<sup>3</sup> See James J. Fishman, *Stealth Preemption: The IRS's Nonprofit Corporate Governance Initiative*, 29 VA. TAX REV. 545, 558-59 (2010) (recounting how tax-exemption application forms like Form 1023 were first released in the early 1950s).

status will be eligible to use Form 1023-EZ.<sup>4</sup> The IRS expects that Form 1023-EZ will more efficiently provide determinations to applicants, preserve accuracy,<sup>5</sup> and enable the IRS to focus on back-end compliance.<sup>6</sup> Yet several commentators, including, perhaps counterintuitively, representatives of large consortiums of nonprofits,<sup>7</sup> have decried Form 1023-EZ as an IRS misstep.<sup>8</sup> Why does this tension exist?

## I. BACKGROUND ON THE FEDERAL INCOME TAX EXEMPTION

Since the early 1950s, organizations seeking federal tax-exempt status under section 501(c) have been required to file Form 1023.<sup>9</sup> Form 1023 began as a four-page questionnaire<sup>10</sup> and has, over the years, grown increasingly complicated.<sup>11</sup> Today's Form 1023 asks for much of the same information requested in 1951, such as particulars on charitable purposes, financials, and organizing documents, but requires much more detail.<sup>12</sup> Unlike prior versions, the modern Form 1023 also requires detailed information on

<sup>4</sup> See I.R.S. News Release IR-2014-77 (July 1, 2014) (announcing that “as many as 70 percent of all applicants” can file using Form 1023-EZ); see also Submission for OMB Review; Comment Request, 79 Fed. Reg. 18,124, 18,125 (Mar. 31, 2014) (noting that an estimated 80,000 respondents would typically apply using Form 1023, but claiming initially that “approximately 17 percent . . . will apply using Form 1023-EZ”). The seventeen percent figure cited in the Federal Register was later deemed erroneous. INTERNAL REVENUE SERV., OMB CONTROL NO. 1545-0056, ICR REFERENCE NO. 201402-1545-033, SUPPORTING STATEMENT FOR PAPERWORK REDUCTION SUBMISSION: FORM 1023 AND FORM 1023-EZ, at 3 (2014), available at <http://www.reginfo.gov/public/do/DownloadDocument?documentID=453380&version=0>, archived at <http://perma.cc/3WLA-7AD9>.

<sup>5</sup> See TAX EXEMPT & GOV'T ENTITIES DIV., INTERNAL REVENUE SERV., IRS CONTROL NO. TEGE-07-0214-02, MEMORANDUM FOR EXEMPT ORGANIZATIONS DETERMINATIONS AND EXEMPT ORGANIZATIONS DETERMINATIONS QUALITY ASSURANCE 1 (2014) (noting how, after the old procedures for exemption determinations suffered from “inaccurate forms,” Form 1023-EZ “simplified” exemption determinations).

<sup>6</sup> See I.R.S. News Release IR-2014-77, *supra* note 4 (commenting that the streamlined process will allow the IRS “to devote more compliance activity . . . to ensure groups are actually doing the charitable work they apply to do”).

<sup>7</sup> The term “nonprofit,” for purposes of this Essay, refers to any organization with 501(c) tax-exempt status.

<sup>8</sup> See *infra* Part III.

<sup>9</sup> Fishman, *supra* note 3, at 558-59.

<sup>10</sup> See, e.g., *Form 1023 Exemption Application*, MED. COLL. OF GA. FOUND., INC. (May 1954), <http://www.mcgfoundation.org/form1023.pdf>, archived at <http://perma.cc/UC66-W596>.

<sup>11</sup> See ADVISORY COMM. ON TAX-EXEMPT & GOV'T ENTITIES, INTERNAL REVENUE SERV., EXEMPT ORGANIZATIONS: FORM 1023—UPDATING IT FOR THE FUTURE, at 6, in PUB. 4344, REPORT OF RECOMMENDATIONS (2012) [hereinafter UPDATING FORM 1023] (“Today’s Form 1023 is a 12-page form with 14 pages of schedules that apply to certain types of organizations, and is accompanied by 38 pages of instructions.”).

<sup>12</sup> See *id.*

compensation practices, conflicts of interest, and transactions with insiders.<sup>13</sup> The most recent significant revision to Form 1023 occurred in 2004 and was intended to “streamline the application process,” promote sound governance, and help the IRS identify “potentially abusive charities.”<sup>14</sup> Despite these earlier efforts to make Form 1023 easier and faster to complete, the current incarnation requires (in the IRS’s own estimation) approximately 105 hours to complete.<sup>15</sup>

Section 501(c) contains many categories of tax-exempt status,<sup>16</sup> but over seventy percent of organizations filing Form 1023 seek classification under section 501(c)(3).<sup>17</sup> Quickly obtaining 501(c)(3) status is especially important for newly formed nonprofits that need startup capital, because 501(c)(3) status is often a prerequisite for receiving competitive grants.<sup>18</sup> Not only are organizations with 501(c)(3) status exempt from paying federal income tax, but contributions to organizations with 501(c)(3) status are deductible by donors when they file their personal income tax returns.<sup>19</sup> The federal

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<sup>13</sup> See *id.*

<sup>14</sup> I.R.S. News Release IR-2004-133 (Nov. 1, 2004); see also ADVISORY COMM. ON TAX-EXEMPT & GOV'T ENTITIES, INTERNAL REVENUE SERV., THE APPROPRIATE ROLE OF THE INTERNAL REVENUE SERVICE WITH RESPECT TO TAX-EXEMPT ORGANIZATION GOOD GOVERNANCE ISSUES, at 32, in PUB. 4344, REPORT OF RECOMMENDATIONS (2008) [hereinafter APPROPRIATE ROLE OF THE IRS] (“[T]he 2004 . . . version [of Form 1023] places an increased emphasis on an organization’s governance by focusing on board and management relationships (independence) as well as compensation and other potential opportunities for inurement.”).

<sup>15</sup> See *supra* note 2 and accompanying text. The Form 1023 released in 1993, in contrast, was estimated to require approximately sixty-eight hours to complete. See INTERNAL REVENUE SERV., CAT. NO. 47194L, APPLICATION FOR RECOGNITION OF EXEMPTION UNDER 501(C)(3) OF THE INTERNAL REVENUE CODE 1 (1993) (listing time estimates for completing Parts I to IV of Form 1023).

<sup>16</sup> These categories include not only organizations seeking section 501(c)(3) status (public charities and private foundations) but also other tax-exempt organizations under section 501(c), such as 501(c)(4) social welfare organizations; 501(c)(5) labor, agriculture, and horticulture organizations; 501(c)(6) business and professional member organizations; and 501(c)(19) veterans’ organizations. See I.R.C. § 501(c) (2012).

<sup>17</sup> In 2013, 1,442,197 organizations had 501(c) status, of which 1,052,495, or seventy-three percent, had 501(c)(3) status. INTERNAL REVENUE SERV., 2013 DATA BOOK 56 (2013) [hereinafter 2013 IRS DATA BOOK].

<sup>18</sup> See, e.g., *Grant Opportunities*, BILL & MELINDA GATES FOUND., <http://www.gatesfoundation.org/How-We-Work/General-Information/Grant-Opportunities> (last visited Sept. 23, 2014), *archived at* <http://perma.cc/F6R7-FL7S> (stating that the foundation gives the majority of its grants to 501(c)(3) organizations); Open Soc’y Inst.—Balt., *Grants: Tackling Drug Addiction*, OPEN SOC’Y FOUNDS. (Apr. 4, 2014), <http://www.opensocietyfoundations.org/grants/tackling-drug-addiction>, *archived at* <http://perma.cc/XV8K-EHXC> (requiring IRS tax-exempt status as part of the grant application).

<sup>19</sup> There are constraints on deductibility. Donors must itemize to obtain the benefit of their contributions, and donation-based deduction limits exist for both individual and corporate taxpayers. See generally I.R.C. § 170(c) (2012) (“[T]he total amount of contributions . . . shall not exceed 30 percent of the taxpayer’s contribution base . . .”).

government implicitly pays for this donation subsidy through foregone federal tax revenue.<sup>20</sup> The importance of determining which organizations should receive 501(c)(3) status is illustrated by the magnitude of this federal subsidy: for 2014, the estimated cost of permitting deductions for charitable contributions is estimated to be approximately \$46.4 billion.<sup>21</sup>

## II. RECENT IRS BUDGET CUTS

Between 2010 and 2014, the IRS's budget was decreased by approximately \$850 million, from \$12.15 billion to \$11.2 billion.<sup>22</sup> The loss of funding is largely the result of political bickering: the amount appropriated to the IRS tends to increase during periods of Democratic control and decrease when Republicans have controlled at least one branch of Congress.<sup>23</sup> Decreases in the IRS's enforcement budget, counterintuitively, result in a net *cost* to the federal government, because of the positive marginal return on investment for each dollar spent on IRS enforcement.<sup>24</sup> President Obama's request to increase the 2015 budget to \$12.4 billion was recently rejected, and IRS funding for next year is set to return to pre-2010 levels of \$10.9 billion.<sup>25</sup>

The IRS employee training budget was sharply reduced in response to the cuts made to the IRS's overall funding.<sup>26</sup> Training for employees in the

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<sup>20</sup> To the extent that states permit deductions of charitable contributions, states also subsidize charitable giving.

<sup>21</sup> See STAFF OF JOINT COMM. ON TAXATION, 113TH CONG., ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 2012–2017 tbl.1 (Comm. Print 2013) (tallying various tax deductions for charitable contributions among other tax expenditure estimates). Note, however, that these estimates are not equivalent to government revenues foregone in the absence of the tax deductions, because tax expenditure estimates do not take into account behavioral responses or changes in the timing of tax payments.

<sup>22</sup> U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-14-534R, INTERNAL REVENUE SERVICE: ABSORBING BUDGET CUTS HAS RESULTED IN SIGNIFICANT STAFFING DECLINES AND UNEVEN PERFORMANCE 8 (2014) [hereinafter GAO REPORT].

<sup>23</sup> Thomas B. Edsall, Op-Ed., *Scandals Republicans Like*, N.Y. TIMES (Apr. 22, 2014), [http://www.nytimes.com/2014/04/23/opinion/edsall-scandals-republicans-like.html?\\_r=1](http://www.nytimes.com/2014/04/23/opinion/edsall-scandals-republicans-like.html?_r=1), archived at <http://perma.cc/96FD-KP2U>.

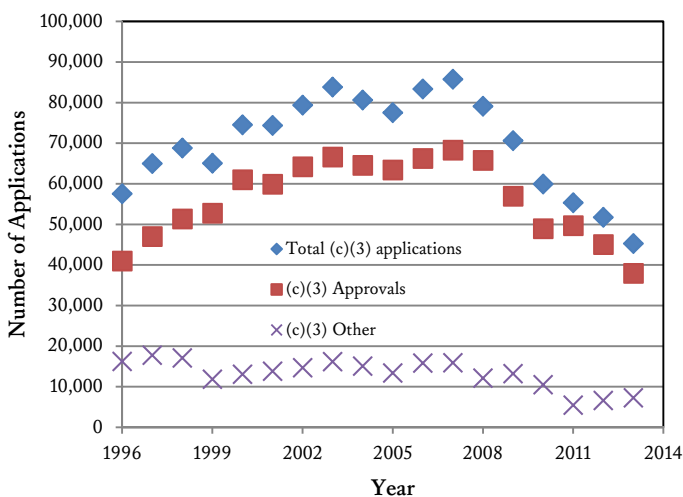
<sup>24</sup> See 1 NAT'L TAXPAYER ADVOCATE, 2013 ANNUAL REPORT TO CONGRESS 21 (2013), available at <http://www.taxpayeradvocate.irs.gov/userfiles/file/2013FullReport/Volume-1.pdf>, archived at <http://perma.cc/H5PM-FSQA> (“[E]ach dollar appropriated for the IRS generates substantially more than one dollar in federal revenue.”).

<sup>25</sup> Paul Bedard, *House Budget Punishes IRS with 15% Cut, Halts Obamacare Enforcement*, WASH. EXAMINER (June 17, 2014, 12:05 PM), <http://washingtonexaminer.com/article/2549830>, archived at <http://perma.cc/PJ44-B9XT>. Between 2010 and 2014, the IRS's enforcement budget decreased from \$5.5 billion to \$5.0 billion. GAO REPORT, *supra* note 22, at 28 tbl.6. Enforcement staffing over the same time period decreased from 50,400 full-time equivalents to 42,805. *Id.* at 29 tbl.7.

<sup>26</sup> Between 2010 and 2013, the training budget decreased from \$170 million to \$22 million. 1 NAT'L TAXPAYER ADVOCATE, *supra* note 24, at 41 fig.1.3.1.

tax-exempt and government entities unit (TE/GE) was especially hard hit: the unit's training budget was reduced by 96%—just 4% of its 2009 levels.<sup>27</sup> However, the TE/GE budget cuts have had little appreciable effect on the rates of approval of applications for 501(c)(3) status. Since 1999, the rate of approvals for applicants seeking 501(c)(3) status has hovered between approximately eighty percent and ninety percent.<sup>28</sup> Perhaps even more telling is that disapprovals over this same period are nearly nonexistent, reaching a *peak* of 1.9% in 2007.<sup>29</sup> Applications for 501(c)(3) status that are properly filled out and not withdrawn by the submitting organizations are thus overwhelmingly likely to obtain approval.

Figure 1: 501(c)(3) Applications by Year<sup>30</sup>



<sup>27</sup> GAO REPORT, *supra* note 22, at 25.

<sup>28</sup> See *infra* Figures 1-2. Between 1993 and 2013, the lowest and highest approval rates of 79.4% and 89.8% occurred in 2003 and 2011, respectively. See *infra* Figure 2.

<sup>29</sup> See *infra* Figure 3. A significant fraction of applications closed (ranging from 9.8% in 2011 to 19.3% in 2003) are neither approved nor disapproved. See *SOI Tax Stats - Closures of Applications for Tax-Exempt Status - IRS Data Book Table 24*, INTERNAL REVENUE SERV., <http://www.irs.gov/uac/SOI-Tax-Stats-Closures-of-Applications-for-Tax-Exempt-Status-IRS-Data-Book-Table-24> (follow hyperlinks to view yearly data) (last updated Mar. 21, 2014), *archived at* <http://perma.cc/5ZVS-6KAE> [hereinafter *SOI Tax Stats*]. These applications include withdrawn or incomplete applications, as well as those where the IRS refused to rule. 2013 IRS DATA BOOK, *supra* note 17, at 55 tbl.24 n.2.

<sup>30</sup> *SOI Tax Stats*, *supra* note 29.

Figure 2: Approval Rate of 501(c)(3) Applications<sup>31</sup>

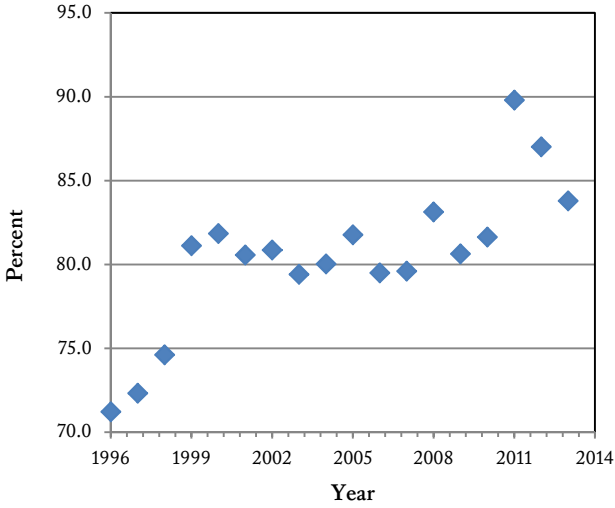
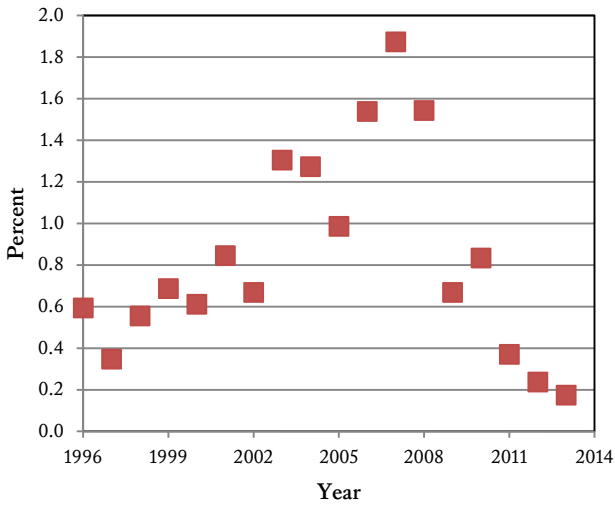


Figure 3: Disapproval Rate of 501(c)(3) Applications<sup>32</sup>



<sup>31</sup> These data were calculated from the raw data charted in Figure 1, *supra*.

<sup>32</sup> These data were likewise calculated from the raw data published in *SOI Tax Stats*, *supra* note 29.

The process of applying for 501(c)(3) status is time-consuming for both applicants and the IRS. In addition to answering the myriad questions presented in the Form 1023, applicants must assemble their governing documents, provide a detailed narrative of their activities, and provide financials for four tax years.<sup>33</sup> The IRS must review these materials and provide feedback.<sup>34</sup> IRS requests for additional information can be laborious and potentially add months to determination time.<sup>35</sup> However, despite the arduous process, the end result is almost always that 501(c)(3) status is granted.<sup>36</sup> For at least two decades, application for 501(c)(3) status has not been competitive.<sup>37</sup> Given the recent IRS budget cuts, Form 1023-EZ's adoption is the practical result of this empirical reality. If nearly all applicants are granted 501(c)(3) status, there is little incentive for the IRS to expend resources on extensively reviewing applications.

### III. PUBLICLY STATED OPPOSITION TO FORM 1023-EZ

Perhaps counterintuitively, several consortiums of nonprofits have expressed opposition to Form 1023-EZ.<sup>38</sup> One such detractor is the National Council of Nonprofits (Council). The Council engages in legislative advocacy, research, report writing, and various other activities to advance the interests of its nonprofit members.<sup>39</sup> With over 25,000 members nationwide, the Council is the largest network of nonprofits in the country.<sup>40</sup>

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<sup>33</sup> See generally FORM 1023 INSTRUCTIONS, *supra* note 2, at 3.

<sup>34</sup> *Id.* at 5 (explaining how the IRS will include feedback for an applicant within twenty-one days after the IRS acknowledges receipt of the applicant's Form 1023 application); cf. 1 NAT'L TAXPAYER ADVOCATE, *supra* note 24, at 165 n.4 ("Organizations consulting the . . . 'Where's My Application?' page on IRS.gov are informed that the IRS might take up to six months after acknowledg[ing] the application to either inform the applicant that the application has been approved or to request additional information.").

<sup>35</sup> See generally UPDATING FORM 1023, *supra* note 11, at 21 (noting that the IRS processing rate would improve under Form 1023-EZ's interactive component, which would eliminate the need to request additional information from applying organizations).

<sup>36</sup> See *supra* note 29 and accompanying text; see also *supra* Figure 3.

<sup>37</sup> See generally *supra* Figures 1-3.

<sup>38</sup> See generally Public Comments to Form 1023-EZ, OMB No. 1545-0056, REGINFO.GOV, [http://www.reginfo.gov/public/do/PRAViewDocument?ref\\_nbr=201402-1545-033](http://www.reginfo.gov/public/do/PRAViewDocument?ref_nbr=201402-1545-033) (last updated June 26, 2014), archived at <http://perma.cc/B74K-NL62>. Thirteen comments were submitted, including comments from representatives of the Center for Nonprofits, Maryland Nonprofits, and the National Council of Nonprofits. *Id.*

<sup>39</sup> See Nat'l Council of Nonprofits, *Comment on Form 1023-EZ*, REGINFO.GOV (Apr. 30, 2014), <http://www.reginfo.gov/public/do/DownloadDocument?documentID=472037&version=1>, archived at <http://perma.cc/MDH2-SDPR> [hereinafter National Council Comment] (noting the Council's core mission "to advance the vital role, capacity, and voice of charitable nonprofit organizations through [its] state and national networks").

<sup>40</sup> *Id.*

On April 30, 2014, in response to the Treasury Department's request for comments on the proposed Form 1023-EZ, the Council submitted a letter detailing the reasons for its opposition.<sup>41</sup> The Council's critiques of Form 1023-EZ are representative of the criticisms offered by other organizational detractors of the new form, such as the National Network of Fiscal Sponsors<sup>42</sup> and Maryland Nonprofits.<sup>43</sup> In the Council's view, Form 1023-EZ (1) decreases the quality of information the IRS needs to make informed determinations; (2) reduces public trust in the nonprofit sector; (3) lacks the educational value for applying organizations contained by the full Form 1023 application process; and (4) improperly shifts the IRS's duties onto the public, existing nonprofits, and state charity regulators.<sup>44</sup>

A. *"Form 1023-EZ Does Not Provide Enough Information for the IRS"*

The Council claims that Form 1023-EZ does not provide enough substance for the IRS to make informed decisions about an applicant's tax-exempt status.<sup>45</sup> But even with the benefit of the full information contained in the original Form 1023, the IRS is often presented not with tangible evidence of a well-functioning nonprofit, but with an aspirational vision of what the applying organization could eventually become.<sup>46</sup> With 501(c)(3) applicant approval rates at 83.8% and disapproval rates at 0.2% in 2013,<sup>47</sup> the IRS is typically not making nuanced decisions with respect to successful applications.

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<sup>41</sup> *Id.*

<sup>42</sup> Fiscal sponsors are tax-exempt organizations that receive charitable donations on behalf of another organization awaiting determination of tax-exempt status. *See generally* *Fiscal Sponsorship*, GRANTSPACE, <http://grantspace.org/tools/Knowledge-Base/Individual-Grantseekers/Fiscal-Sponsorship/fiscal-sponsorship> (last visited Sept. 23, 2014), *archived at* <http://perma.cc/AW7S-47X9>.

<sup>43</sup> *See generally* Maryland Nonprofits, *Comment on Form 1023-EZ*, REGINFO.GOV (Apr. 30, 2014), <http://www.reginfo.gov/public/do/DownloadDocument?documentID=472014&version=1>, *archived at* <http://perma.cc/D24T-SBXW>; *see also* Nat'l Network of Fiscal Sponsors, *Comment on Form 1023-EZ*, REGINFO.GOV (Apr. 30, 2014), <http://www.reginfo.gov/public/do/DownloadDocument?documentID=472013&version=1>, *archived at* <http://perma.cc/NFN8-LR48>. It is worth noting that the California Association of Nonprofits supports adoption of Form 1023-EZ. *See* Cal. Ass'n of Nonprofits, *Comment on Form 1023-EZ*, REGINFO.GOV (Apr. 29, 2014), <http://www.reginfo.gov/public/do/DownloadDocument?documentID=472010&version=1>, *archived at* <http://perma.cc/7NQ9-PAJU>.

<sup>44</sup> *See* National Council Comment, *supra* note 39.

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

<sup>46</sup> *See generally* FORM 1023 INSTRUCTIONS, *supra* note 2, at 8 (contemplating that applicants will describe not just past and present activities on Form 1023, but also future *planned* activities).

<sup>47</sup> *See supra* figure 2 (charting yearly approval rates); *see also* *Closures of Applications for Tax-Exempt Status, by Organization Type and Internal Revenue Code Section, Fiscal Year 2013*, INTERNAL REVENUE SERV. (2013), [http://www.irs.gov/file\\_source/pub/irs-soi/13db24eo.xls](http://www.irs.gov/file_source/pub/irs-soi/13db24eo.xls), *archived at* <http://perma.cc/JZB5-FHNV> (listing 501(c)(3) approvals and disapprovals in 2013).



### B. "Form 1023-EZ Will Undermine Public Trust of Nonprofits"

The Council's worry that Form 1023-EZ will undermine public trust in the nonprofit sector is also unconvincing. Bad actors wishing to abuse the tax-exemption process find no real obstacle in the original Form 1023: publicly available templates exist for nearly all required elements.<sup>48</sup> The full Form 1023 is thus burdensome only for those completing the application in good faith, while those desiring to abuse the system can do so with a modicum of effort. In addition, Form 1023-EZ is only available to organizations with annual gross receipts of \$50,000 or less and total assets of \$250,000 or less.<sup>49</sup> Organizations with the largest ability to undermine the public trust are therefore precluded from the streamlined tax-exemption process.

### C. "Filing the Original Form 1023 Educates Organizations"

According to the Council, filing the original Form 1023 has a salutary effect on applying organizations.<sup>50</sup> Requiring applicants to consider topics such as conflicts of interest, sources of funding, and concerns over self-dealing, the argument goes, builds a foundation of strong corporate governance and makes organizations less likely to be subject to IRS enforcement actions.<sup>51</sup> As the Council notes, this general line of reasoning was also advanced by the Advisory Committee on Tax Exempt and Government Entities.<sup>52</sup> However, the Advisory Committee has also stated that while the IRS's efforts to encourage strong corporate governance may matter, "there is little or no empirical support for the proposition that requiring specific governance practices results in greater compliance with the tax laws pertinent to exempt organizations."<sup>53</sup> In short, there is no evidence that the chore of completing the original Form 1023 results in better functioning tax-exempt organizations.<sup>54</sup>

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<sup>48</sup> See, e.g., Sandra Deja, *Prepare Your Own 501(c)(3) Application*, 501C3BOOK.COM, [http://501c3book.org/Form1023\\_2.html](http://501c3book.org/Form1023_2.html) (last visited Sept. 23, 2014), archived at <http://perma.cc/G93B-EWHQ> (providing an "accurate, up-to-date, plain English ebook" to help applicants file their 501(c)(3) applications); *Nonprofit 501(c)(3) Articles of Incorporation Sample, How to Write One*, FORM1023.ORG, <http://form1023.org/how-to-draft-articles-of-incorporation> (last visited Sept. 23, 2014), archived at <http://perma.cc/YYYY2-VCPP> (providing a template for a nonprofit's articles of incorporation).

<sup>49</sup> See FORM 1023-EZ INSTRUCTIONS, *supra* note 2, at 11.

<sup>50</sup> See National Council Comment, *supra* note 39.

<sup>51</sup> *Id.*

<sup>52</sup> *Id.*; see also UPDATING FORM 1023, *supra* note 11, at 31-32 ("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.").

<sup>53</sup> APPROPRIATE ROLE OF THE IRS, *supra* note 14, at 4.

<sup>54</sup> It is conceivable that organizations subject to the full Form 1023 might benefit in ways other than just increased tax compliance. Form 1023-EZ attempts to address this possibility by

D. “Form 1023-EZ Improperly Shifts Burdens of the IRS”

The Council also asserts that Form 1023-EZ will improperly shift the burdens of the IRS onto taxpayers, existing nonprofits, and state governments because (1) taxpayers will be faced with more expensive back-end enforcement actions, (2) existing nonprofits will lose credibility due to the glut of new nonprofits, and (3) state governments will no longer be able to defer to the IRS’s “known-to-be-tough scrutiny in the tax-exempt determinations process.”<sup>55</sup>

1. To Taxpayers

The reallocation of IRS resources from reviewing applications to back-end enforcement, as discussed above, represents a more efficient allocation of resources since back-end enforcement has the potential to reveal abuses by existing nonprofits. In contrast, reviewing exemption applications from nascent organizations has little effect on ultimate determinations and has little predictive benefit for identifying the likelihood of potential future abuse. Because the IRS budget is fixed, allocating more funds to enforcement improves compliance without, as the Council claims, imposing any additional burden on taxpayers.

2. To Existing Nonprofits

An increase in the number of nonprofits operating within a charitable sector would not diminish their collective credibility. A number of freely available resources exist to help donors identify trustworthy nonprofits.<sup>56</sup> Credibility of nonprofits is undermined when nonprofits engage in abusive behavior. Form 1023-EZ’s adoption will result in an increased TE/GE enforcement budget. This additional oversight will encourage compliance by nonprofits and, as a result, will *increase* credibility.

An increase in the number of nonprofits might indeed increase competition between nonprofits with similar charitable missions, but this outcome would not be unfair. As in competition between for-profit entities, a new nonprofit entering the space in which existing nonprofits operate should thrive, even if at a cost to existing nonprofits, if the new nonprofit can more efficiently accomplish the charitable goals of its donors. This increased

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encouraging filers to review its online guide to charities and other nonprofits. *See, e.g.*, FORM 1023-EZ INSTRUCTIONS, *supra* note 2, at 2 (referring applicants to the IRS website for information about how 501(c)(3) exempt status also means the applicants’ documents will be available for public inspection).

<sup>55</sup> *See* National Council Comment, *supra* note 39.

<sup>56</sup> Examples include Charity Navigator, GuideStar, and the United States Better Business Bureau.

competition could help highlight existing nonprofits that are poorly run or that inefficiently accomplish their stated charitable missions.

### 3. To State Charity Regulators

As discussed, the IRS's tax-exempt determination process is time-consuming and onerous, but not especially rigorous.<sup>57</sup> Form 1023 is largely aspirational, and tax-exemption approvals are largely granted based on an organization's plans rather than on its substance. Provided that applicants do not submit materials contradicting applicable law, there is an overwhelming likelihood that approval will be granted.<sup>58</sup> State charity regulators that do not defer to IRS determinations bear an increased burden, but their efforts would also provide valuable additional oversight.

## IV. EXISTING NONPROFITS' PRACTICAL OPPOSITION TO FORM 1023-EZ

We should not be surprised that existing nonprofits, including members of the Council and of the National Network of Fiscal Sponsors, are opposed to Form 1023-EZ's adoption. Existing nonprofits gained tax-exempt status through the original Form 1023, which, for most applicants, required a significant amount of effort. Given that these existing organizations already have 501(c)(3) status and derive no benefit from filing a Form 1023-EZ, they have no incentive to make obtaining exemptions any simpler for newcomers. For these organizations, Form 1023-EZ represents a discount on something they have already purchased. In addition, Form 1023-EZ causes existing nonprofits to be subject to increased oversight: savings generated from the streamlined form will be used to enforce tax-exempt compliance on the back end (by examining existing nonprofits' operations), rather than on the front end (by examining prospective nonprofits' exemption applications).<sup>59</sup>

Existing nonprofits also have an incentive to limit the number of tax-exempt organizations operating within their charitable sector. An abundance of nonprofits in the same charitable sector results in increased competition for contributions, and increases the accountability nonprofits have to the public.

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<sup>57</sup> See *supra* Section III.A.

<sup>58</sup> See generally *supra* Figures 2-3 (charting the high approval rates and low disapproval rates).

<sup>59</sup> See Diane Freda, *IRS to Roll Out Form 1023-EZ in Summer, Anticipates Little Risk of Noncompliance*, BLOOMBERG BNA (Apr. 25, 2014), <http://www.bna.com/irs-roll-form-n17179889907>, archived at <http://perma.cc/6Q2H-M5A6> ("There will be a robust compliance process at the back end, whether it be through compliance checks or full examinations . . .").

Fiscal sponsors also have an interest in limiting the number of organizations with tax-exempt status. Fiscal sponsors generate revenue by accepting donations on behalf of organizations yet to obtain 501(c)(3) status. Form 1023-EZ, by minimizing the tax-exemption barrier to entry, will allow new organizations to more quickly and easily obtain 501(c)(3) status. As a result, the market available for fiscal sponsors will inevitably shrink.

Form 1023-EZ's adoption will likely result in increased oversight and additional competition for existing nonprofits. These reasons, rather than the ones asserted publicly by the Council, are more plausible rationales for the Council's (and for other nonprofits') opposition to Form 1023-EZ.

#### CONCLUSION

The current process of obtaining tax-exempt status is needlessly onerous and can be especially burdensome for small organizations. Form 1023-EZ's release at least partially addresses these concerns while simultaneously alleviating IRS budgetary pressures. The benefits of allowing organizations to quickly obtain tax-exempt status outweigh the hypothetical benefits of obtaining governance expertise by filing the more cumbersome Form 1023. It is no surprise that many existing nonprofits are opposed to Form 1023-EZ since its adoption will result in increased enforcement for all nonprofits, both new and old, and will increase the overall number of 501(c)(3) organizations. This protectionist position, though understandable, ultimately harms the charitable sector. Existing nonprofits should thrive because they accomplish their charitable missions more efficiently than their peers, not because their potential peers are excluded.

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