

To: Andres Garcia

From: Sandy Deja

RE: OMB Control No. 1545-0047

Please change Form 1023-EZ, Part IV, Foundation Classification, Question 2

The error in this question and related instructions has cost thousands of small applicants for 501(c)(3) status needless time and expense filing for a corrected determination. Changes in this question could save small charities millions of dollars and reduce paperwork for both the IRS and the public.

Error in Public Charity Question

Form 1023-EZ introduced a change in how 501(c)(3) applicants were asked the "public charity" question. Question 2 of Part IV of Form 1023-EZ begins, "If you qualify for public charity status, check the appropriate box..." Prefacing the public charity question with "if you qualify" is a radical departure from 501(c)(3) applications that came before 1023-EZ, where applicants were simply asked to indicate the type of public charity status they were requesting, without asking them to assert anything about whether they currently qualified.¹

Asking the public charity question in this way is not only new with the 1023-EZ, but also mostly wrong. About 90% of approved Form 1023-EZ filers are "new" organizations, less than 5 years old.² The Income Tax Regulations provide a test *specifically* for new organizations seeking public charity status: can the organization reasonably be expected to meet the requirements of the 33⅓ percent support test?³

You will look in vain, however, for any mention of a "reasonable expectation" rule in Form 1023-EZ or its instructions.⁴ The instructions, instead, tell applicants not to check a box in Question 2 of Part IV until after they have completed a seven step 33⅓% computation⁵ (nine steps for those seeking 509(a)(2) status). The only special rule for new organizations is to perform the public charity computation using revenue actually received since formation, together with revenue anticipated for the balance of the organization's first 5 years of existence.⁶

This "project future support and calculate public percentage" procedure is not found in the law. Whether a new organization can reasonably be expected to be publicly supported, according to the Regulations, is determined by organizational structure, current or proposed programs or activities, and actual or intended methods of operation. **No computations of any kind are mentioned.**⁷

Please Change Form 1023-EZ, Part IV, Foundation Classification, Question 2, cont.

It is not clear why the instructions for Form 1023-EZ disregard the clearly stated "reasonable expectation" standard set forth in the Regulations and, instead, impose a stricter "project and calculate" rule not even mentioned in the law.⁸ What **is** clear is that by disregarding the plain meaning of the Regulations, this question on Form 1023-EZ has resulted in unnecessary time, expense and paperwork for small public charities, and has wasted IRS resources.

Cost of Erroneous Private Foundation Determinations

Since Form 1023-EZ was introduced in 2014, about 442,000 organizations have obtained "streamlined" recognition of exempt status. About 44,000 of them were determined to be private foundations.⁹

An organization that finds itself with an incorrect private foundation determination has three choices:

- File IRS Form 8940 to obtain a corrected ruling,
- Go out of business, or
- Live with the private foundation determination

The costs are easiest to estimate for the 1023-EZ private foundations who are now considered public charities. Slightly less than one sixth of the 1023-EZ users who received a private foundation determination have made this change; roughly 6,400 of them have filed Form 8940.¹⁰ This represents between \$2,500,000 and \$3,000,000¹¹ in needless Form 8940 User Fees, more than 88,000 hours of time to prepare and file the form,¹² and an unknown amount of professional fees.

Other costs are very real, but difficult to estimate. In mid-November of 2022, irs.gov says that it is taking over 6 months to process Form 8940.¹³ During this wait, many will find that funders prefer not to make grants to private foundations. Many will have trouble meeting their annual filing requirements: instead of the handful of questions on Form 990-N they expected to answer, organizations will find they are liable for the 13-page 990-PF.

(Every needless Form 8940 also represents an outlay of IRS resources that might have been avoided if Form 1023-EZ and the instructions had accurately described the public charity test for new organizations. The Taxpayer Bill of Rights says that taxpayers have the right to know what is needed to comply with the tax laws. What is the cost when voluntary compliance is undermined by incorrect IRS instructions?)

More than twice as many EZ private foundations, close to a third of them, simply gave up on exempt status. Eventually, most of these groups were automatically revoked.¹⁴ It is impossible to estimate the cost of well over ten thousand non-profit organizations abandoning their efforts to help their communities.

Please Change Form 1023-EZ, Part IV, Foundation Classification, Question 2, cont.

The balance, about half the 1023-EZ users who received a private foundation determination, are still considered private foundations. Many of these organizations may have intended to operate as private foundations; they have not been harmed by the erroneous instructions in Form 1023-EZ.

Those organizations that **were** harmed were those who might have been able to meet a 33⅓% public support test at the end of their first five years, but were not given the opportunity. They will experience the on-going costs and frustrations of reluctant grantors and inappropriate annual filings described above.

Suggested wording¹⁵

2. Select the foundation classification you are requesting from the list below.¹⁶

- ☐ Select this box to attest that you reasonably expect to receive at least 1/3 of your support from public sources. **Sections 509(a)(1) and 170(b)(1)(A)(vi).**¹⁷
- ☐ Select this box to attest that you reasonably expect to receive more than one third of your support from a combination of gifts, grants, contributions, membership fees and gross receipts from activities related to your exempt function and not more than one third of your support from investment income and unrelated business income. **Section 509(a)(2).**
- ☐ Select this box to attest that you are operated for the benefit of a college or university that is owned or operated by a governmental unit. **Sections 509(a)(1) and 170(b)(1)(A)(iv).**

The instructions, of course, would have to be changed. Suitable wording can be found in the instructions for Form 990, Schedule A or in IRS Publication 557, both of which state the public charity test for new organizations correctly.

Conclusion: Form 1023-EZ, Part IV, Question 2 must be changed

1023-EZ filings are trending upwards, and on July 1, 2022, the User Fee for Form 8940 was increased to \$550. If one sixth of the EZ private foundations approved since this fee increase file Form 8940 for a corrected ruling, the IRS will collect nearly a quarter of a million dollars in needless User Fees from these "successful" EZ applicants alone.

To summarize, Form 1023-EZ, Part IV, Question 2 must be changed because it is wrong, it is inconsistent with other IRS guidance, it has cost small charities millions of dollars, it has wasted IRS resources, and it is getting worse. Making this suggested change will enhance the quality and clarity of Form 1023-EZ and remove unnecessary roadblocks for PTAs, youth sports leagues, animal welfare organizations, environmental groups and other small charities just trying to help their communities.¹⁸

Notes

1. Question 5, Part X, [Form 1023, Rev. December, 2013](#):
"If you answered "No" to line 1a, indicate the type of public charity status you are requesting by checking one of the choices below. You may check only one box. The organization is not a private foundation because it is:"
2. Determined by comparing the "Incorporateddate" and "Signaturedate" fields in the Form 1023-EZ Approval Data databases available at <https://www.irs.gov/charities-non-profits/exempt-organizations-form-1023-ez-approvals>.
3. [Section 1.170A-9\(f\)\(4\)\(v\)\(A\)](#) of the Income Tax Regulations:
(v) *Normally; first five years of an organization's existence.*
(A) An organization "normally" receives the requisite amount of public support and meets the 33⅓ percent public support test or the facts and circumstances test during its first five taxable years as a section 501(c)(3) organization if the organization can reasonably be expected to meet the requirements of the 33⅓ percent support test
4. Curiously, the original instructions for Form 1023-EZ **did** mention the reasonable expectation rule: "For a newly formed organization, the test is whether the organization can reasonably be expected to meet the requirements of the 33⅓% public support test or the 10% public support plus facts and circumstances test during its first five taxable years as a section 501(c)(3) organization." [1023-EZ Instructions \(Rev. August, 2014\) page 9](#). When this wording was removed from revised instructions issued in 2018, the proportion of EZ approvals receiving private foundation determinations *jumped from less than 7.5% (2017) to over 10% (2018), and has been above 10% every year since!* <https://www.irs.gov/charities-non-profits/exempt-organizations-form-1023-ez-approvals>.
5. Page 10, [1023-EZ instructions \(Rev. January 2018\)](#) "Line 2a. Check this box if after completing Steps 1–7 below, you meet the requirements for the 509(a)(1) public support test."
6. Page 9 of [1023-EZ instructions](#) "If you are a new organization, base your determination on the types, sources, and amounts of revenue you actually received since your formation, together with the types, sources, and amounts of revenue you anticipate you will receive over the first 5 years of your existence."
7. Section [1.170A-9\(f\)\(4\)\(v\)\(A\)\(f\)\(4\)\(v\)\(B\)](#) of the Income Tax Regulations. Income Tax Regulation Section [1.509\(a\)-3\(d\)\(1\)](#) provides a similar "first five years" rule for 509(a)(2) public charities, even going so far as to say "regardless of the public support [the organization] in fact receives" in Example 1 of Section 1.509(a)-3(e)(3).
8. My guess is that when the drafters of Form 1023-EZ realized the new form would have no financial data the IRS could use to establish that an applicant was publicly supported, it seemed appropriate to ask applicants themselves to make a support computation. What the 1023-EZ fails to take into account is the benefit of the doubt that regulatory authority has accorded to new 501(c)(3)s ever since the public charity/private foundation distinction was made part of tax law more than 50 years ago. In its initial form, this was called the "Advance Ruling" program.
9. Combined totals from all EZ databases at <https://www.irs.gov/charities-non-profits/exempt-organizations-form-1023-ez-approvals>: total approvals 442,329; total PFs: 43,974.
10. Organizations that have changed foundation classification determined by comparing all EZ-approved EINs to a current Exempt Organization Business Master File found at <https://www.irs.gov/charities-non-profits/exempt-organizations-business-master-file-extract-eo-bmf>
11. Based on the average Form 8940 User Fee from 2014 to the present.
12. Hours to compete and file Form 8940 taken from the Paperwork Reduction Act Notice in the [Form 8940 instructions \(Rev. January 2018\)](#).

13. <https://www.irs.gov/charities-non-profits/charitable-organizations/wheres-my-application-for-tax-exempt-status>
14. Determined by comparing all EZ-approved EINs to a current Auto-Revocation List found at <https://www.irs.gov/charities-non-profits/tax-exempt-organization-search-bulk-data-downloads>
15. Ideally, I would like to see an option like the one included in the long-form 1023: "You are a publicly supported organization and would like the IRS to decide your correct classification." Of course, I realize this would undermine a major reason for adopting the streamlined 1023 in the first place...
16. This wording is taken straight from page 15 of the Electronic "long-form" 1023 (Rev. January, 2022) Question 1, Part VII, Form 1023, (Rev. January, 2020)
17. Including wording here that covers the 10% Facts & Circumstances test seems unnecessary to me. If a reasonable expectation is enough to meet the 33⅓% public support test, meeting the 10% F & C is not an issue.
18. Note that changing this question on the EZ would also make it consistent with Publication 557 and with Schedule A of Form 990 and its instructions:
 "Special computation period for new organizations (Computation period for public support).
 If, at the time of applying for tax-exempt status, an organization can reasonably be expected to meet the one-third support test or the facts and circumstances test during its first 5 tax years, the organization will qualify as publicly supported for its first 5 years." Publication 557 (Rev. January, 2022) page 34
 13 **"First 5 years.** If the Form 990 is for the organization's first, second, third, fourth, or fifth tax year as a section 501(c)(3) organization, check this box and stop here" and "An organization that checks this box should stop here and shouldn't complete the rest of Part II. It shouldn't make a public support computation on line 14 or 15 or check any of the boxes on lines 16 through 18"
 2021 990 Schedule A - Part II, Section B, Question 13, page 2 of form and page 7 of instructions.

Contact Information

Sandy Deja

