

Systemic Advocacy Management System (SAMS) Issue Confirmation

Thank you for participating in the Systemic Advocacy Program.

Your issue was received: 1/10/24, 2:32 PM and assigned Issue # 70427

Brief issue description:

Form 1023-EZ, Part IV, conflicts with IRS Regs, costs charities millions and wastes IRS resources.

Detailed issue description:

Form 1023-EZ, meant to streamline the 501(c)(3) application process, has, instead, harmfully prolonged the process for tens of thousands of small charities. Half of 1023- EZ private foundation classifications appear to be wrong. Many of these applicants actually meet IRS guidelines for public charity status. Misclassifications mean millions of dollars in unnecessary IRS fees, missed funding opportunities, unanticipated paperwork, even loss of exempt status. In addition, misclassifications are a damper on charitable activity and a needless drain on scarce IRS resources.

Form 1023-EZ, introduced in 2014, and its instructions, are to blame. Part IV of Form 1023-EZ, Foundation Classification, is oddly worded and ignores the public charity tests that specifically apply to most 1023-EZ applicants. The more detailed description of the public support tests for new charities in the EZ instructions simply does not appear in any other current IRS guidance. Providing inconsistent guidance is a violation of the taxpayer's right to be informed.

The obvious solution would be to change the wording of Part IV of Form 1023-EZ and its instructions to make them consistent with tax law and with other similar IRS Forms. A more comprehensive solution would include stepped-up IRS review of Forms 1023-EZ that indicate private foundation status, as well as User Fee adjustments.

Actions Taken: If any of the IRS offices I have contacted about this issue have taken action, I am not aware of it. Although I have also alerted EO tax professionals and non-profits themselves, it is really up to the IRS to fix this.

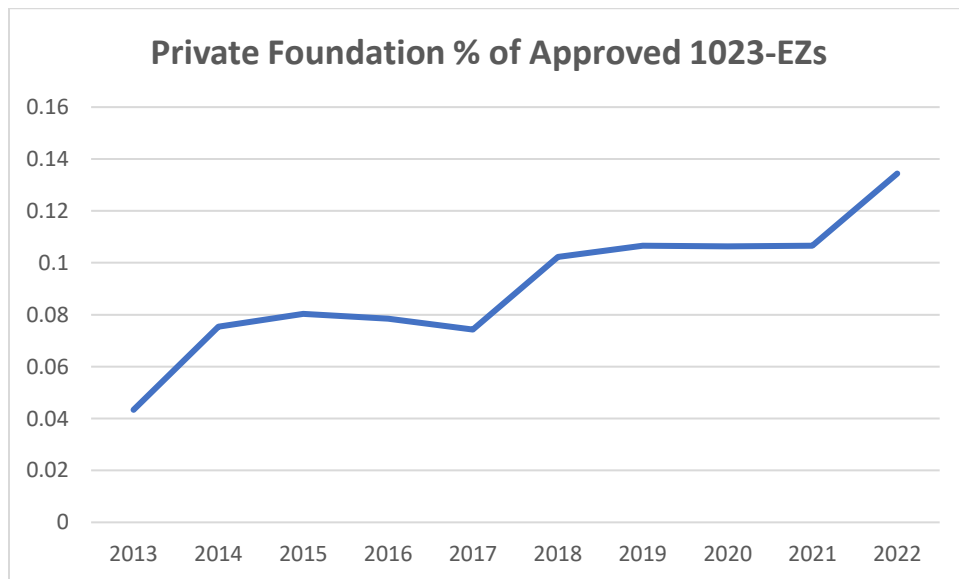
The 2,000 character limit for Form 14411 means that relevant authorities and guidance, sample language, examples, charts, links and a more complete description of actions taken have been omitted from this submission. Please email me at sssandydeja@gmail.com for this background documentation.

Form 1023-EZ, meant to “streamline” the 501(c)(3) application process, has, instead, harmfully prolonged the process for tens of thousands of small charities.

Charitable, educational, etc. organizations, tax exempt under Section 501(c)(3), are classified as either public charities or private foundations, based on the types of support received. Once an organization has been misclassified as a private foundation, files IRS Form 8940, and pays the \$550 User Fee for reclassification, it can take a year or more before the IRS finally records a correction in their database of charities. Harms to small charities resulting from this delay are described in detail below in *Misclassifications mean millions of dollars...*

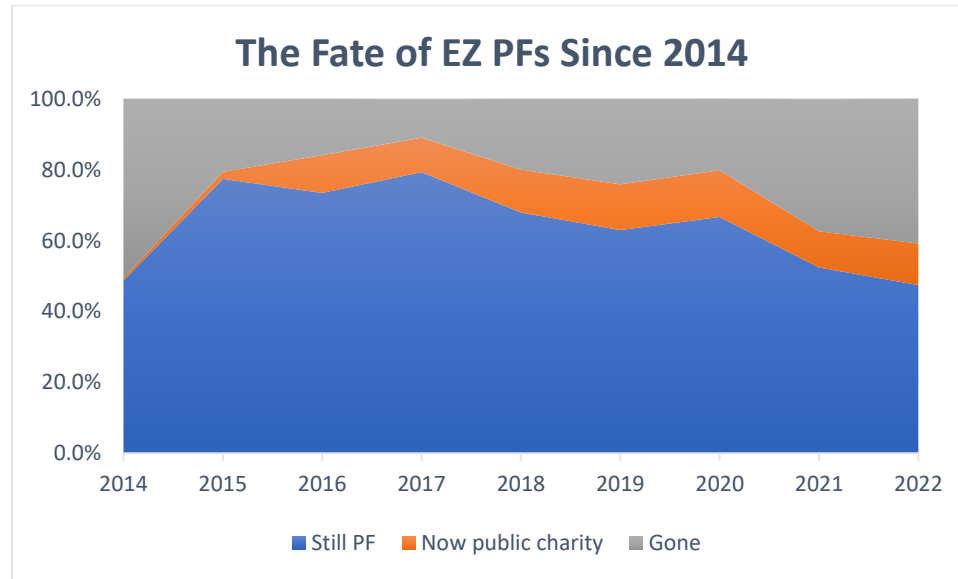
Half of 1023-EZ private foundation classifications appear to be wrong.

The percentage of newly approved small 501(c)(3)s classified as private foundations immediately jumped in 2014 when Form 1023-EZ was introduced and has steadily increased. In 2013, before Form 1023-EZ, less than 5% of newly approved 501(c)(3) organizations were private foundations. The chart below shows increases since then. (There have not been any significant changes to public charity/private foundation law during this time.)



By the end of 2014, less than a year after the introduction of Form 1023-EZ, misclassified 1023-EZ users were already applying for and receiving reclassification. By the end of 2022, close to 9,000 EZ-origin private foundations (almost 20% of the 9-year total) had applied for and received reclassification, and an additional 30% had disappeared from the IRS database of charities. At the end of 2022, less than half of 1023-EZ applicants initially determined to be private foundations still had that status. In contrast, close to three quarters of applicants determined to be private foundations back in 2013, pre-1023-EZ, still had that status in late 2023.

(Late breaking news: The IRS approved 66,751 Forms 1023-EZ in 2023. 10,559 (**15.6%!**) were classified as private foundations.)



Many of these applicants actually qualify for public charity status.

Separate Test for New Organizations: Around 90% of 1023-EZ applicants had not completed their first five years before applying. Under current tax law, start-up 501(c)(3)s are entitled to the benefit of the doubt when it comes to the public charity support tests. The Income Tax Regulations set forth a separate test specifically for new organizations: an organization that can **reasonably be expected** to meet a public charity support test by the end of its first 5 tax years will qualify as publicly supported for its first 5 years "...regardless of the level of public support it in fact receives during this period." T.D. 9423, [73 FR 52533](#).

NTEE Categories - Traditional Public Charities: Some types of organizations have historically met the public charity tests. PTAs, for instance, are usually supported by dues and by fundraisers such as book fairs, bake sales and field days - all sources of public support. In 2013, two PTAs were approved as 501(c)(3) private foundations. Since the introduction of Form 1023-EZ, on average more than 80 Parent-Teacher organizations have ended up as private foundations every year. (**Late breaking news:** In 2023 alone, 171 PTAs were classified as private foundations.) Similar stories could be told for senior centers, youth development organizations, food banks, animal shelters, and no doubt many others. It is very likely that most of these organizations have been misclassified.

Mission Statements: A hallmark of a public charity, according to the Income Tax Regulations, is "continuous and bona fide efforts to raise funds." Since 2018, Form 1023-EZ has asked applicants for a brief Mission Statement. The words "raise funds," "fundraising," "collect funds," "solicit" and similar terms are specifically mentioned in thousands of the mission statements of approved private foundations. These organizations clearly indicated to the IRS that they expect public support, but ended up as private foundations anyway. It is very likely that most of these organizations have also been misclassified.

Misclassifications mean millions of dollars in unnecessary IRS fees, missed funding opportunities, unanticipated paperwork, even loss of exempt status, [and] are a damper on charity.

Unnecessary User Fees: There is no publicly available information about the User fee paid by specific Form 8940 filers, but there have been nearly 9,000 successful reclassifications. Using an average User Fee of \$445, small charities have paid at least \$3.5 million to correct Form 1023-EZ foundation classification errors. Based on time estimates in the instructions for the one page paper Form 8940, preparing and filing these forms would have taken more than 100,000 hours. No data is available about Form 8940 denials, if any. Those organizations would also have spent time and money on Form 8940.

Missed funding opportunities: Many private foundation grantors will not make grants to other private foundations because of additional record-keeping requirements. Many public grantors will not make grants to private foundations in order to avoid the appearance of diverting public money to private uses. Many popular on-line fundraising opportunities are not available to charities classified as private foundations.

Unanticipated paperwork: In addition to the hours spent completing Form 8940 to request reclassification, misclassified 1023-EZ users find that instead of the handful of questions on Form 990-N they expected to answer, they are required to file the much more complex 13-page annual Form 990-PF.

Loss of exempt status: By the end of 2022, nearly 19,000 EZ applicants approved as private foundations had lost their 501(c)(3) status. Many no doubt succumbed to automatic revocation for failure to file, but there can be little doubt that limited fundraising opportunities, complex filing requirements, and the costs and delays associated with correcting a misclassification played a large part.

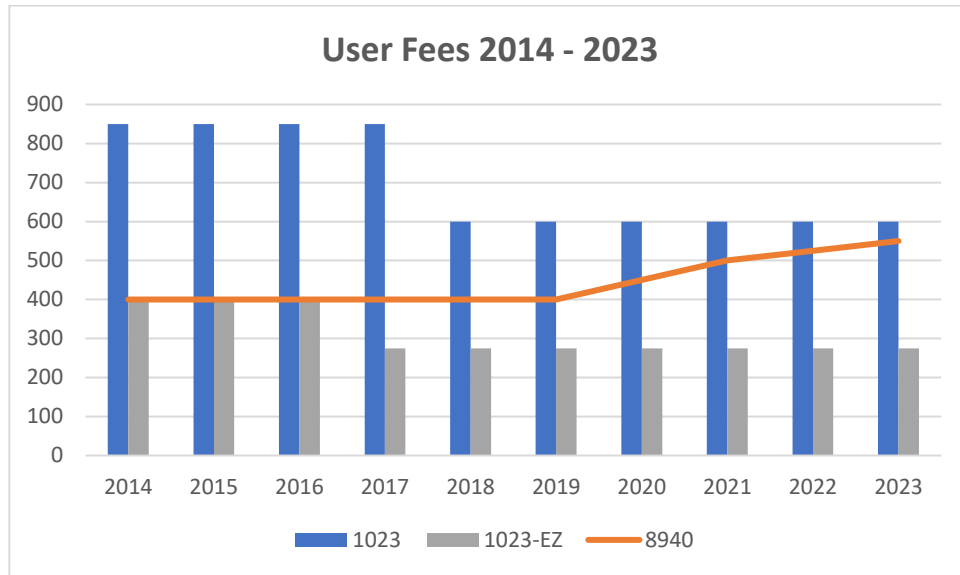
Damper on Charitable Activity: It is impossible to estimate the costs to society of almost twenty thousand non-profit organizations abandoning their efforts to help their communities.

Misclassifications are a needless drain on scarce IRS resources.

There does not seem to be any publicly available information on the cost to the IRS of processing Forms 8940, but there is plenty of indirect evidence suggesting the “burden” created by Form 8940 is increasing.

User Fees: The IRS reviews User Fee charges every two years to ensure rates are adjusted to reflect changes in costs. The User Fee for Form 8940 (orange in the chart below) has increased steadily since 2019, during a time when User Fees for both 1023-EZ (grey) and the long form 1023 (blue) have been decreasing.

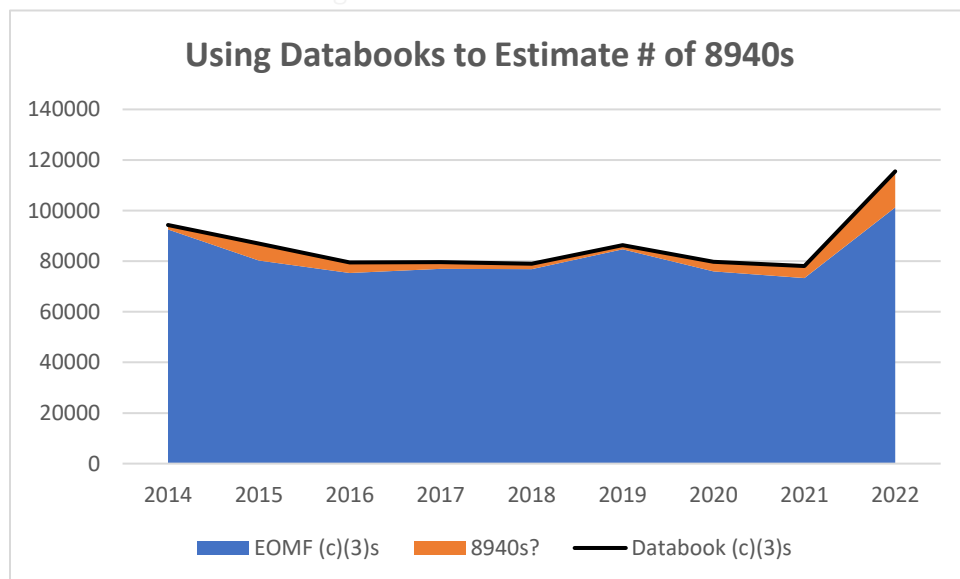
(Late breaking news: the IRS has announced that the User Fee for Form 8940 foundation reclassification will increase to \$600 on July 1, 2024.)



Processing Time: Form 8940 has a lengthy processing time. In figures released by the IRS in November, 2023, the average age of Form 8940 cases was the highest of any determination category, at 113 days. The average processing time for Form 8940 was second highest at 164 days. (Form 8940 is used for a dozen types of miscellaneous determinations. I am under the impression that foundation status reclassifications are the most common.)

Number of Form 8940 Submissions: The IRS has estimated an annual “burden” of 2,100 Forms 8940 in every Paperwork Reduction Act submission since the form was introduced in 2011, but it appears that actual receipts have sometimes far exceeded that number. Cha

rt: Using Databo to Estimate # of 8940s



There is no publicly available IRS database that directly reports the annual number of Forms 8940. A footnote to Table 12 of the annual IRS Databook, however, suggests Forms 8940 are included in those totals. “These include not only initial applications for tax-exempt status, but also other determinations such as public charity and private foundation status determinations...” The chart above “backs into” an annual estimate of Forms 8940 by comparing Database totals with publicly available Exempt Organization Master File data. The black line at the top edge of the orange area shows the total Databook (c)(3) “approval” closures for each year. The blue area below shows the total number of (c)(3) entities on the Exempt Organizations Master File with “ruling dates” for the same year. The difference between the two (orange) suggests that Form 8940 submissions are increasing, reaching over 10,000 in 2022.

Electronic Form 8940: It is too soon to assess the impact of the early 2023 switch from a one page paper Form 8940 to a 46 page electronic form, but changing Form 8940 is not the answer to the problem described here. As explained below, it is the Form 1023-EZ that needs to change in order to stop this needless drain on IRS resources

Form 1023-EZ, introduced in 2014, and its instructions, are to blame. Part IV of Form 1023-EZ, Foundation Classification, is oddly worded and ignores public charity tests that specifically apply to most 1023-EZ applicants. The more detailed description of the public support tests for new charities in the EZ instructions simply does not agree with other current IRS guidance.

Problems with Part IV: If an applicant checks the box on Form 1023-EZ with the wording below, the organization is classified as a private foundation (Part IV, Question 3):

<p><input type="radio"/> Select this box to attest that your organizing document contains the provisions required by section 508(e) or that your organizing document does not need to include the provisions required by section 508(e) because you rely on the operation of state law in your particular state to meet the requirements of section 508(e). (See the instructions for explanation of the section 508(e) requirements.)</p>

Contrast this with the private foundation question on the 2006 Form 1023, when private foundation classifications were around 5%...

<p>1a Are You a private foundation? If “Yes,” go to line 1b. If “No,” go to line 5... <input type="checkbox"/> Yes <input type="checkbox"/> No</p>

...or with the private foundation question on the now electronic long-Form 1023:

<p>1 Select the foundation classification you are requesting from the list below.</p> <p>...</p> <p>...</p> <p><input type="radio"/> You are a private foundation.</p>

Form 1023-EZ, Part IV, Question 3, quoted above, which notably only asks about compliance with Section 508(e), is preceded by a short paragraph concluding that the applicant must be a private foundation because it is not described in one of the Part IV, Question 2 boxes. But Part IV,

Question 2 fails to describe the correct public charity tests for around 90% of 1023-EZ applicants: new organizations that have not completed their first five years. There is another off-ramp on the road to private foundation status that is simply never mentioned in Part IV of Form 1023-EZ.

Problems with Instructions: The Form 1023-EZ instructions also ignore this alternate route. New organizations are told to use revenue actually received since formation, together with revenue anticipated for the balance of the organization's first 5 years of existence to complete a seven step 33⅓% computation (nine steps for those seeking 509(a)(2) status). The Regs section [1.170A-9\(f\)\(4\)\(v\)\(A\)](#) "reasonable expectation" test for new organizations is not described at all in the 1023-EZ instructions.

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

In addition to the Regulations, the IRS provides guidance on the public charity/private foundation tests in [Revenue Ruling 2018-5](#), [Publication 557 - Tax Exempt Status for Your Organization](#), [Publication 4220 - Applying for 501\(c\)\(3\) Tax Exempt Status](#), [Publication 4221-PC - Compliance Guide for 501\(c\)\(3\) Public Charities](#), [Form 990 Schedule A](#) and [instructions](#), and in the long-form 501(c)(3) application and [instructions](#). Not one of these sources of guidance mentions the "project and calculate" procedure.

The original 1023-EZ instructions, issued in 2014, accurately described the public charity tests for new organizations. The "project and calculate" procedure, unsupported by any published IRS guidance, appeared when the instructions for Form 1023-EZ were revised in 2018. Information about provisions in the Regulations that could benefit small charities seeking 501(c)(3) recognition was simply dropped.

Unsurprisingly, the percentage of private foundation EZ approvals took an upturn at around the same the revised instructions were issued (see the "Private Foundation % of Approved 1023-EZs" chart above). The User Fee for Form 8940 also began to rise shortly after that (see the "User Fees 2014 – 2023" chart above). Anecdotally, this is about when I began to hear from non-profits that needed help completing Form 8940.

Providing inconsistent guidance is a violation of the taxpayer's right to be informed.

A tax form that disagrees with all other IRS guidance and fails to mention well established tax law that applies to 90% of the form's users is seriously flawed. Form 1023-EZ violates the taxpayers' Right to Be Informed.

The Right to be Informed Taxpayers have the right to know what they need to do to comply with the tax laws. They are entitled to clear explanations of the laws and IRS procedures in all tax forms, instructions, publications, notices,

and correspondence. They have the right to be informed of IRS decisions about their tax accounts and to receive clear explanations of the outcomes.

The instructions for Part IV of Form 1023-EZ include this message: “You are solely responsible to check the line on Part IV of Form 1023-EZ that corresponds to your correct foundation classification. We will process your application with the classification you indicate based upon your representations.” If a disclaimer like this makes it OK to keep 1023-EZ applicants in the dark about their legal options, then the taxpayers’ “Right to be Informed” does not mean much.

The most obvious solution would be to change the wording of Part IV of Form 1023-EZ and its instructions to make them consistent with the law and other similar IRS Forms.

Suggested Wording for Part IV: Why not have the wording of Form 1023-EZ, Part IV, Foundation Classification, mirror the wording in Form 1023, Part VII, Foundation Classification? An eligibility warning could be added to public charity statuses that are not available to Form 1023-EZ users.

1 Select the foundation classification you are requesting from the list below.

You are described in 509(a)(1) and 170(b)(1)(A)(vi) as an organization that receives a substantial part of its financial support in the form of contributions from publicly supported organizations, from a governmental unit, or from the general public.

You are described in 509(a)(2) as an organization that normally receives not more than one-third of its financial support from gross investment income and receives more than one-third of its financial support from contributions, membership fees, and gross receipts from activities related to its exempt functions (subject to certain exceptions).

You are described in 509(a)(1) and 170(b)(1)(A)(i) as a church or a convention or association of churches. **Stop. Do not file Form 1023-EZ. See the Eligibility List in the Instructions.**

You are described in 509(a)(1) and 170(b)(1)(A)(ii) as a school. **Stop. Do not file Form 1023-EZ. See the Eligibility List in the Instructions.**

You are described in 509(a)(1) and 170(b)(1)(A)(iii) as a hospital, a cooperative hospital service organization, or a medical research organization operated in conjunction with a hospital. **Stop. Do not file Form 1023-EZ. See the Eligibility List in the Instructions.**

You are described in 509(a)(1) and 170(b)(1)(A)(iv) as an organization operated for the benefit of a college or university that is owned or operated by a governmental unit.

You are described in 509(a)(1) and 170(b)(1)(A)(ix) as an agricultural research organization directly engaged in the continuous active conduct of agricultural research in conjunction with a college or university. **Stop. Do not file Form 1023-EZ. See the Eligibility List in the Instructions.**

You are described in 509(a)(3) as an organization supporting either one or more organizations described in 509(a)(1) or 509(a)(2) or a publicly supported section 501(c)(4), (5), or (6) organization. **Stop. Do not file Form 1023-EZ. See the Eligibility List in the Instructions.**

You are described in 509(a)(4) as an organization organized and operated exclusively for testing for public safety. **Stop. Do not file Form 1023-EZ. See the Eligibility List in the Instructions.**

You are a publicly supported organization and would like the IRS to decide your correct classification.*

You are a private foundation.

* Additional IRS scrutiny of a “Streamlined” form may not be practical/possible.

This change in Part IV would add a couple of inches to the text in Form 1023-EZ. There is currently more than twice that amount of blank space on the third page of the form.

Suggested Wording for Instructions: Why not simply add back the instructions for new organizations that were already included in the 2014 and 2017 instructions but deleted in 2018? Of course, the sections of the current instructions that tell new organizations to make a calculation based on “revenues you have actually received since your formation as well as revenues you anticipate,” should be removed.

Stepped Up IRS Review: A quick IRS review of Forms 1023-EZ that have checked Question 3 of Part IV, though undoubtedly helpful, might also be at odds with the “streamlined” intent of Form 1023-EZ. IRS management must decide whether employee time and IRS resources are better spent on processing Forms 8940 or on issuing correct determinations in the first place by identifying and following up with EZ applicants that have checked the “private foundation” box, but whose NTEE codes or mission statements point to public charity status.

User Fee Adjustments: An additional idea for dealing with these misclassifications would be to lower the User Fee for reclassification (Schedule G of Form 8940). The current fee of \$550 – twice the 1023-EZ User Fee – is a steep price to pay for mistakenly checking a poorly explained box on Form 1023-EZ. Different Form 8940 miscellaneous determinations already have different User Fees.

Actions taken:

Commented on Part IV of Form 1023-EZ when a draft was released in early 2014. Commented again in November of 2022, in response to an IRS request for public comments on Form 1023-EZ. Explained in detail why I thought Part IV of Form 1023-EZ should be changed. Also included comments about Part IV of Form 1023-EZ as part of a more general discussion of Form 1023-EZ in mid-2021 with the office of the Treasury Inspector General for Tax Administration (by email and teleconference). If any action was ever taken in response to these contacts, I am unaware of it.

Reached out to Exempt Organizations tax professionals through letters and comments to a specialized journal for EO practitioners and submitted a Form 1023-EZ, Part IV question to the TEGE Exempt Organizations Council for an IRS Q & A session scheduled for their June, 2023, meeting.

Added free detailed instructions for completing Form 8940 to my website. Corresponded with hundreds of non-profits who have found themselves in the exact predicament described here. (A few of these people believe Pay.gov changed their Form 1023-EZ, Part IV answers after they left the page. Some others wondered whether this happened because the IRS needs the additional Form 8940 User Fees to make up for years of underfunding.)

I asked my Representative to add wording to an appropriations bill that would require greater IRS review of 1023-EZ applicants that “claimed” private foundation status.

I am a mostly-retired tax consultant specializing in Form 1023. I was an IRS Exempt Organizations Specialist from 1973 to 1986. Sandy Deja / easandc3book@gmail.com / Fairbanks, Alaska