NATIONAL COUNCIL OF NONPROFITS

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April 6, 2018

The Honorable Lynn Jenkins
Chairman
Subcommittee on Oversight
Committee on Ways and Means
United States House of Representatives
Washington, DC 20515

The Honorable John Lewis
Ranking Member
Subcommittee on Oversight
Committee on Ways and Means
United States House of Representatives
Washington, DC 20515

RE: **Comments on the Discussion Draft: The Taxpayer First Act**

Dear Chairman Jenkins and Ranking Member Lewis,

The National Council of Nonprofits appreciates your March 26 invitation to submit comments on the Discussion Draft of the bipartisan Taxpayer First Act, and we are pleased to do so now.

We offer these comments from the perspective of the charitable nonprofit community, a major segment of the U.S. economy that employs more than 14 million taxpayers and that interacts with the Internal Revenue Service in many ways. The National Council of Nonprofits (Council of Nonprofits) is a trusted resource and proven advocate for America's charitable nonprofits. Working with and through the nation's largest network of nonprofits – with more than 25,000 organizational members – we identify emerging trends, share proven practices, and promote solutions that benefit charitable nonprofits and the communities they serve.

The Council of Nonprofits commends you for addressing numerous challenges that taxpayers face when they have reasons to engage with the IRS. While not all problems are the fault of outdated technology and bureaucratic impediments – the prolonged underfunding of the agency being a notable problem leading to many challenges – the legislation appears to provide specific, targeted fixes that could improve performance and taxpayer experiences.

As a starting matter, we ask that the Subcommittee recognize as it evaluates the Taxpayers First Act that charitable nonprofits serve every community in our country, interact with taxpaying residents on a daily basis, and submit to the IRS a variety of tax forms, including annual informational tax returns like the Form 990. It is essential that any legislation, and the IRS, extend the same rights and benefits to 501(c)(3) organizations as to other organizations.

The National Council of Nonprofits has long supported, and continues to support, the provisions incorporated into **Sec. 522. Mandatory electronic filing for annual returns of exempt organizations**. Electronic filing of Form 990s, Form 1099s, and other forms is likely to improve accuracy and timeliness, while also enhancing public trust in the transparency and integrity of the charitable nonprofit community.

We devote the remainder of our comments on the Taxpayers First Act to an issue that is not in the Discussion Draft, but one we believe is essential to the proper enforcement of tax law related to tax-exempt entities.

Addressing the Challenges of IRS Form 1023-EZ

RECOMMENDATION: Include in the Taxpayers First Act a provision that revokes the existing IRS Form 1023-EZ and instructs the IRS to replace it, after consultation with charitable organizations, foundations, and state charities officers, with a streamlined form that continues to collect essential information that will better protect the public from scam artists and ensure that the IRS grant tax-exempt status only to eligible organizations.

In 2014, the IRS radically streamlined its application and approval process for certain organizations seeking tax-exempt status under Section 501(c)(3) of the Internal Revenue Code. In doing so, it ignored strong opposition and warnings expressed by its own Advisory Committee on Tax Exempt and Government Entities, the National Association of State Charity Officials (state regulators of nonprofit entities), and the National Council of Nonprofits, among others. The IRS made the change for management reasons of reducing a large backlog of applications for tax-exempt status as 501(c)(3) charitable nonprofits. Nobody disputes that the longer Form 1023 is cumbersome and needs work. But the abbreviated Form 1023-EZ eliminated so much information that the IRS can no longer make an informed decision about whether an applicant is eligible under existing statutory requirements.

By using the new Form 1023-EZ, organizations applying under the streamlined procedures are not required to submit information proving that they qualify for tax-exemption. According to the Taxpayer Advocate (Annual Report to Congress, FY 2017), "the new procedures do not require applicants to submit their articles of incorporation or bylaws to ensure they are properly organized and have adopted the appropriate charitable purpose clause as well as protections against misuse of funds."

The Taxpayer Advocate's conclusion, quoted above, is not surprising; indeed, it was predicted when the Form 1023-EZ was first proposed. Representatives of the charitable community and the law-enforcement community, as well as accounting and legal professionals, expressed strong opposition to the rubber-stamp process and the specifics of the form out of concern that the IRS was abdicating its role in preventing unqualified or bad actors from receiving tax-exempt status and preying on the public.

In an op-ed published in *The Hill* (Express lane to more trouble for the IRS?, June 2, 2014), Tim Delaney, President and CEO of the National Council of Nonprofits, identified three overarching concerns with the adoption of the Form 1023-EZ application and review process:

1) ***Public trust***. Protecting public trust is essential for nonprofits to operate. The new form will cause distrust as sham operators secure tax-exempt status.
2) ***Responsibility***. If the IRS abdicates its assigned duty as gatekeeper, then who will determine whether applicants legitimately deserve charitable status?
3) ***Concern for taxpayers***. The IRS' intentional shift from preventive front--end enforcement to reactive back-end is like saying, "We'll enforce *after* a car wreck," instead of doing its best to keep ill-prepared -- or worse – impaired drivers off the road.

See also National Council of Nonprofits comments, submitted to the Office of Management and Budget, April 30, 2014.

These concerns largely parallel the objections raised by the National Association of State Charity Officials (NASCO) in a letter to the IRS. NASCO – the organization representing state charity regulators, including those in state Attorney General Offices, Secretary of State Offices, and other

state offices charged with preventing the misuse of charitable assets — cautioned that "the Form 1023-EZ fails to obtain the minimum amount of information necessary to identify organizations that should not be approved or should be monitored more closely in back-end compliance." NASCO provided a list of essential information needed on the form to enhance charities law enforcement, including formal documents of the organization, compensation data, financial reporting, organizational history, and other information. The IRS ignored the informed requests of these law enforcement officials tasked with protecting the public. *See* also NASCO's formal submission.

The IRS's own Advisory Committee on Tax Exempt and Government Entities (ACT) provided extensive recommendations in the 2012 ACT Report of Recommendations on the question of a streamlined application process for 501(c)(3) organizations, all of which the IRS ignored in implementing the Form 1023-EZ. Listed in the ACT's "**Rationale for Not Developing a Form 1023-EZ**" was recognition that "Form 1023 serves an important educational purpose for applying organizations," namely, through its questions "the form forces the applying organization to think somewhat deeply about its activities, finances, and management." ACT went on to observe that the form "also signals to the organization that it is entering into a (probably unfamiliar) comprehensive regulatory scheme, and working through the questions on the form provides the organization with a great deal of information about compliance with this regime." The ACT members went on to warn presciently "that it would be difficult to design a significantly shorter Form 1023 … that would still provide the IRS with all the essential information it needs to make a determination" on an organization's eligibility. Much to the concern of the regulated and regulating communities, the IRS ignored this sound advice of its own handpicked advisors.

Unfortunately, the charitable community, state law enforcement, and the IRS's own advisory group of tax accountants and attorneys accurately predicted the disaster that has been unfolding since the Form 1023-EZ went live. In our view, the most recent annual report to Congress from the Taxpayer Advocate Service (at page 26) makes the case most succinctly for revoking the Form 1023-EZ and starting over:

> Taxpayer Advocate Service (TAS) studies carried out in 2015 and 2016 showed, respectively, that 37 percent and 26 percent of approved entities in one of 20 states that post articles of incorporation online did not meet the organizational test for qualification as an Internal Revenue Code (IRC) § 501(c)(3) organization. This year's [2017] TAS study of a representative sample of approved Form 1023-EZ applicants from those same 20 states found an erroneous approval rate of 42 percent. Meanwhile, the more detailed Form 1023 processing time, 96 days in Fiscal Year (FY) 2016, rose to 113 days for FY 2017. Thus, Form 1023-EZ as implemented created a new risk — erroneous grants of tax exemption — yet may not have solved the initial problem of long processing times for Form 1023.

The news release for these FY 2017 TAS report results is perhaps even more informative about the impact of the problems that the Form 1023-EZ create:

> The report says that erroneous grants of tax-exempt status can have significant repercussions. They can harm the organizations by failing to give them an opportunity to correct problems before they begin operations. They can reduce federal revenue by allowing organizations that should be paying tax to avoid it and by allowing donors to claim tax deductions for contributions to organizations that should not be treated as tax exempt. Erroneously recognizing organizations as exempt also can undermine public trust in the integrity of the charitable sector.

See Taxpayer Advocate Service FY 2017 Annual Report to Congress, Form 1023-EZ, Adopted to Reduce Form 1023 Processing Times, Increasingly Results in Tax Exempt Status for Unqualified Organizations, While Form 1023 Processing Times Increase, January 10, 2018. [1]

Conclusion and Solution to IRS Form 1023-EZ

By any measure, the problems with the express-lane approach to tax exemption continue and, indeed, are increasing. Virtually every entity that applies using the Form 1023-EZ receives tax exempt status – thanks in part to erroneous approvals at rates of 37, 26, and 42 percent during 2015, 2016, and 2017, respectively. And the IRS' primary obligation of preventing ineligible organizations and perhaps bad actors from receiving and exploiting tax-exempt status for personal gain is being shirked with every application processed. IRS Form 1023-EZ should be withdrawn immediately.

Some streamlining is no doubt warranted so that new and emerging organizations are not unnecessarily hindered in their efforts to contribute to their communities as charitable nonprofits. Since the Form 1023-EZ is an example of what not to do, we encourage the Subcommittee to instead create a process that can bring together the parties most committed to the integrity of the charitable nonprofit community to identify appropriate and inappropriate criteria that must be established to demonstrate an organization's commitment and capacity to perform at the high standards that the law requires. Organizations that have demonstrated a commitment to the integrity of the sector through comments on the Form 1023-EZ include the National Council of Nonprofits and the National Association of State Charity Officials. There are many other organizations at the local, state, and federal levels that the Subcommittee and the IRS could tap to provide insights into the proper workings of effective organizations, and, thus, offer their expertise to a Form 1023-EZ rewrite process.

Respectfully submitted,

David L. Thompson
Vice President of Public Policy

[1] Given the other provisions in the Discussion Draft calling for modernizing the IRS, it is worth noting that the 2012 ACT report "strongly" reiterated another ACT Report issued 15 years ago "that the IRS develop a fully e-fileable Form 1023" because it would be "the best way for the IRS to achieve a higher level of efficiency in the handling and review of 1023 forms" by helping to "eliminate filing errors, provide an opportunity to include greater educational content in the software, … and further other important public and governmental objectives." The 2012 ACT members – like us now – were not against fixing the broken parts of the Form 1023; quite the contrary, everyone wants that. What seemingly everyone except the IRS is concerned about is that the obviously defective EZ form opens the door for bad actors to abuse the public under the guise of being tax exempt simply because the IRS did not request or have the data needed to assess legal eligibility.