

Advisory Committee on Tax Exempt and Government Entities  
(ACT)

“PROJECT ASPIRE”  
EO DETERMINATIONS PROCESS REVIEW  
PROJECT GROUP

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## TABLE OF CONTENTS

I.	Executive Summary.....	1
II.	Background.....	3
III.	Project Goals.....	5
IV.	Project Process.....	5
V.	Steps Already Taken.....	6
	<i>Form 1023 Revision Project.....</i>	<i>6</i>
	<i>Determination Letter Revision Project.....</i>	<i>7</i>
	<i>Educational Initiatives.....</i>	<i>8</i>
	<i>TE/GE Call Site.....</i>	<i>8</i>
	<i>Case Assignment Guide Revision.....</i>	<i>9</i>
	<i>Tax-Exempt Determination System.....</i>	<i>9</i>
VI.	Recommendations.....	10
	1. <i>Develop Fully Interactive Form 1023.....</i>	<i>10</i>
	2. <i>Develop Fully e-Fileable Form 1023.....</i>	<i>11</i>
	3. <i>Facilitate Development of Form 1023 Database.....</i>	<i>12</i>
	4. <i>Develop Prominent Form 1023 “Helpful Hints” Checklist.....</i>	<i>12</i>
	5. <i>Conform Two Public Support Tests.....</i>	<i>13</i>
	6. <i>Eliminate Form 8734 at End of Advance Ruling Period.....</i>	<i>14</i>
	7. <i>Specify Particular Section 509(a)(3) Test in Form 1023 and in         Determination Letter.....</i>	<i>15</i>
	8. <i>Develop Standard Public Charity Reclassification Process.....</i>	<i>16</i>
	9. <i>Develop Standard, “One-Stop” Name-Change Process.....</i>	<i>17</i>
	10. <i>Link IRS Website to State Charity Officials’ Website.....</i>	<i>17</i>
VII.	Concepts for Further Consideration.....	18
	A. <i>Increase Form 1023 Filing Threshold.....</i>	<i>18</i>
	B. <i>Adopt Registration System with Operational Follow-Up.....</i>	<i>19</i>
	C. <i>Develop Separate Form 1023-PF.....</i>	<i>19</i>
	D. <i>Develop Separate Form 1023-EZ.....</i>	<i>20</i>
	E. <i>Institute Regular Operational Review.....</i>	<i>20</i>
	F. <i>Eliminate Form 1023 Filing for Certain Reincorporations.....</i>	<i>21</i>

## **I. EXECUTIVE SUMMARY**

Over the past ten years, the number of exemption applications filed annually has increased by 40%, reaching 87,000 in 2002. Over the same 10-year period, EO staffing has remained essentially static, currently at the level of approximately 790 nationwide. As a result of this situation, the percentage of the EO workforce devoted to the determinations (application) function has reached historically high levels. This has left relatively fewer employees dedicated to the examinations function. For 2002, the EO examinations rate was less than 1%.

Wishing to advise TE/GE on ameliorating this situation, the Project Group undertook a comprehensive review of the EO determinations process with a view toward reforming or replacing that process. Streamlining the EO determinations process would enable EO to increase its focus on compliance, which is essential to the integrity of the tax-exempt sector. In addition, the Project Group sought to address the needs of EO applicants for a determinations process that is accessible, comprehensible, reliable, and timely.

The Project Group gathered information and statistics, and conducted interviews with a number of individuals both within and outside TE/GE. The ABA Tax Section Exempt Organizations Committee participated in the process through presentation of two panel discussions held in October 2002, the first dealing with Form 1023 and the current EO determinations process, and the second envisioning an EO determinations process of the future. Participants at these sessions provided valuable input. The Project Group also reviewed a sample of over 100 administrative records in order to better understand the EO determinations process from the perspective of the applicant as well as TE/GE.

The Project Group monitored the progress of various TE/GE initiatives already in progress in order to assess their potential impact on the EO determinations process. These included the Form 1023 revision project, the determination letter revision project, various customer educational initiatives, the TE/GE Call Site, the case assignment guide revision, and the Tax-Exempt Determination System. The Project Group provided ongoing, substantive input to TE/GE with respect to these initiatives, and encourages TE/GE to continue these efforts.

On the basis of all information, comments and suggestions gathered throughout the EO determinations review process, the Project Group presents 10 recommendations for improvement of the EO determinations process, which are outlined briefly below. Several recommendations are logical extensions of the ACT's Life Cycle of a Public Charity and Life Cycle of a Private Foundation recommendations, which were made at the June 2002 public meeting.

1. Develop Fully Interactive Form 1023. The Project Group recommends that TE/GE continue efforts to develop and fund a fully interactive Form 1023

(“CyberAssistant”) that will be posted on the IRS website and integrated with the IRS Life Cycle webpages.

2. Develop Fully e-Fileable Form 1023. The Project Group recommends that TE/GE continue its efforts to develop and fund a fully e-fileable Form 1023 that will be posted on the IRS website and integrated with the IRS Life Cycle webpages and CyberAssistant.

3. Facilitate Development of Form 1023 Database. The Project Group recommends that, as Forms 1023 are electronically imaged or filed, TE/GE facilitate development of a database of completed Forms 1023 that will be searchable by organizational type, state of location, and other relevant parameters.

4. Develop Prominent Form 1023 “Helpful Hints” Checklist. The Project Group recommends that TE/GE develop a prominent checklist of “helpful hints” to be added to the Form 1023 application package to assist non-represented or first-time applicants who are unfamiliar with the “ins and outs” of the process.

5. Conform Two Public Support Tests. The Project Group recommends that the two existing public support tests in section 509(a)(1) and section 509(a)(2) be conformed, with a consistent support definition, appropriate qualification threshold, consistent 2 percent limitation, alternative facts-and-circumstances test, and clear instructions regarding the steps an organization must take when it falls below the minimum standards for qualification

6. Eliminate Form 8734 at End of Advance Ruling Period. The Project Group recommends elimination of Form 8734 at the end of the advance ruling period for publicly supported organizations. Instead, the final determination of public support should be made on the basis of the Schedule A to Form 990 containing 5 years’ financial information.

7. Specify Particular Section 509(a)(3) Test in Form 1023 and in Determination Letter. The Project Group recommends that Form 1023 be revised to require applicant organizations to specify the particular section 509(a)(3) test under which they intend to qualify, and that determination letters issued to section 509(a)(3) supporting organizations specify the particular test under which they have qualified for section 509(a)(3) status.

8. Develop Standard Public Charity Reclassification Process. The Project Group recommends development of a convenient, standardized public charity reclassification process, whereby an existing public charity can report relevant changes in activities or support, and obtain a revised determination letter reflecting its new public charity status or its reclassification as a private foundation.

9. Develop Standard, “One-Stop” Name-Change Process. The Project Group recommends the development of a convenient, standardized process whereby an

exempt organization can report a name change for all IRS purposes and obtain a revised determination letter reflecting the organization's new name.

10. Link IRS Website to State Charity Officials' Website. The Project Group recommends that the IRS website include links to state charity officials' websites through the Life Cycle webpages and through CyberAssistant.

In addition to these recommendations, the Project Group also identified several concepts for improving or revising the determinations process that are presented in the interest of stimulating further discussion and development among interested stakeholders. These concepts are noted briefly below.

- A. Increase the Form 1023 filing threshold from \$5,000 to \$25,000.
- B. Eliminate the Form 1023 filing requirement in favor of a simple registration system with an operational review after an appropriate period of time.
- C. Develop a separate Form 1023-PF for organizations that know they wish to be classified as private foundations.
- D. Develop a separate Form 1023-EZ for small organizations that fall below the current \$5,000 or other filing threshold, e.g., \$25,000.
- E. Institute a system of regular operational reviews conducted at 3-year, 5-year, or some other appropriate interval after initial recognition of exemption.
- F. Eliminate the Form 1023 filing requirement for organizations that move from one state to another and reincorporate in the second state without any other material changes.

## **II. BACKGROUND**

EO determination applications are processed principally at the IRS determination processing center in Cincinnati, Ohio<sup>1</sup>. During 2002<sup>2</sup>, the Cincinnati processing center received almost 87,000 applications, the vast majority of which (91 percent) were Form 1023 applications for recognition of section 501(c)(3) status. This is an increase over the 86,000 applications filed during 2001, and continues the 10-year trend, which has seen a 40 percent increase in total applications, from 63,000<sup>3</sup> in 1993 to 88,000 in 2002.

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<sup>1</sup> Full geographical centralization of determinations processing will not be accomplished in the foreseeable future. Thus, although all applications are submitted to the Cincinnati office, processing of a significant minority of applications will continue to occur at various satellite sites around the country. However, centralized reporting will be accomplished with all EO determinations staff, wherever located, reporting to one of two new area managers.

<sup>2</sup> Unless otherwise noted, references are to the IRS fiscal year, October 1 – September 30.

<sup>3</sup> Eighty-four (84) percent of these applications were Forms 1023.

During 2002, approximately 87,000 applications were closed. The physical processing of each exemption application at the Cincinnati determination processing center involves no fewer than 20 distinct steps. During 2002, the average processing time per application was 3 hours, and the average cycle time<sup>4</sup> was 105 days. Eighty (80) percent of the applications were approved. Thirty-two (32) percent of the approved applications were sufficiently complete to be approved on the merits without any further contact between the applicant and the EO determination specialist (“merit closures”). Approximately 12 percent were “failure to establish” cases, namely, applications that were missing certain required information and were closed administratively after the applicant failed to respond to IRS inquiries within the requisite 35 days.

Over the 10-year period 1993-2002, total EO staffing has remained relatively stable, hovering between 750 and 850. The current EO staffing level is approximately 750, at the lower end of the 10-year range. With a relatively static workforce and a dramatically increased determinations workload, the percentage of the EO workforce devoted to the determinations function has reached historically high levels. Recently, authorization was given for the realignment of approximately 100 EO examination agents solely to the determinations function<sup>5</sup>. It is not anticipated that additional EO staff will be assigned to the determinations function.

Thus, the primary challenge is to address the increasing demands on the EO determinations function, which has left relatively fewer employees available for the examinations function. During 2002, the examinations rate with respect to some 1.5 million exempt organizations was less than 1 percent. Given the unlikelihood that EO determinations workload will decrease or staffing will increase in the foreseeable future, the determinations process must become more efficient and less time-consuming, without sacrificing the integrity of the process, if additional attention is to be given to the essential examinations function.

In an effort to increase compliance within the EO community, EO examinations intends to establish the Exempt Organizations Compliance Unit (“EOCU”) and a data analysis unit during 2004. These two units will enable EO to meet the increasing challenges presented by the growth in the EO sector and a declining examinations rate. The EOCU will address customer non-compliance through correspondence and telephone contacts. The data analysis function will investigate emerging compliance trends to improve return selection for soft contacts and examinations, as well as future compliance projects.

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<sup>4</sup> Cycle time refers to the number of days elapsed from the time an application first enters the determinations system to the time it exits the system through closure or otherwise.

<sup>5</sup> These examination agents had, in fact, been performing determinations work, but now have been formally assigned to the determinations function.

### **III. PROJECT GOALS**

With this background and the approval of the entire ACT, the Project Group undertook a comprehensive review of the EO determinations process with a view toward recommending a range of alternatives for reforming or replacing that process. In addressing this task, the Project Group sought to take into account both the needs of TE/GE to administer an application review program in an accurate, complete, and impartial manner, and the needs of EO applicants for a determinations program that is accessible, comprehensible, reliable and timely.

“Project ASPIRE”, the informal name given to the this determinations process project by the Project Group, reflects specific subsidiary goals of the EO determinations review conducted by the Project Group: A = alleviate any application backlog; S = streamline the determinations process; P = prioritize application review; I = improve customer service; R = redirect resources to cases deserving enhanced review and compliance; and E = enhance quality control.

### **IV. PROJECT PROCESS**

The Project Group gathered information and statistics, and conducted interviews with a number of individuals both within and outside TE/GE. The IRS TE/GE interviewees included Steven Miller, Lois Lerner, Marv Friedlander, and Tom Miller of TE/GE - Washington, DC; Cindy Westcott and Janna Skufca of TE/GE – Cincinnati, OH; and Mike Rachael of TE/GE – Atlanta, GA. Members of the Project Group also conducted structured interviews<sup>6</sup> with Marc Owens [Caplin & Drysdale, Washington, DC, former Director, EO Division], Celia Rody [Morgan, Lewis & Bockius, Washington, DC], Paul Streckfus [Paul Streckfus’ EO Tax Journal, Pasedena, MD], Betsy Adler, Terry Miller and Ruth Masterson [Silk, Adler & Colvin, San Francisco, CA], Linda Manley [director of filings, Lawyers Alliance of New York, New York City, NY], Jay Rotz [Webster, Chamberlain & Bean, Washington, DC, former Executive Assistant, EO Division], and Peter Turk and Marnie Berk [New York Lawyers for the Public Interest, New York City, NY].

Victoria Bjorklund, chair of the ABA Section of Taxation Exempt Organizations Committee and Project Group member, was instrumental in developing two panel presentations on the EO determinations process that were delivered during the Exempt Organizations Committee meeting on October 18, 2002. The first panel addressed Form 1023 and the current EO determinations process. Presenters were Lois Lerner, Director, Rulings and Agreements, and Cindy Wescott, then-EO Program Analyst,

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<sup>6</sup> Structured interviews conducted by the Project Group followed a questionnaire developed by the Project Group, which covered the following: issues in the current EO determination process (length of time, merit closure, impact on exam function, reviewer training, deficiencies in Form 1023, advanced ruling period, etc.); potential remedies (improvement of Form 1023, quality control, training, registration in lieu of application, etc.); and open-ended questions on development of the EO determinations process of the future. Interviewees were also asked to identify other individuals that the Project Group should contact.

Cincinnati. The highlight of this discussion was a video depiction of the physical EO determination process in Cincinnati that had been viewed previously by members of the Project Group. Ms. Lerner and Ms. Wescott also outlined the work of the EO Customer Satisfaction Team, headed by Ms. Wescott, in revising Form 1023 and commonly-used form determination letters.

Participants in the second panel, entitled *Shaping the IRS Determination Process of the Future*, were LaVerne Woods [Davis Wright Tremaine, Seattle, WA], Dick Gallagher [Foley & Lardner, Milwaukee, WI] (for Jody Blazek); Alexis Neely [Munger, Tolles & Olson, Los Angeles, CA], and Jennifer Franklin [Simpson Thacher & Bartlett, New York City, NY]. The panel offered suggestions for improving the EO determinations process on a range of organizational and operational issues, assistance in the preparation of Form 1023, Form 1023 design, the application process, the determination letter, and post-determination follow-up.

Approximately 100 ABA members attended these panels and participated in the question and answer periods that followed. In addition, the transcript of the approximately three-hour session was published in the December 2002 edition of the Exempt Organization Tax Review and was posted on several other websites.

Finally, the Project Group spent two days in Washington, DC reviewing 108 administrative records. These records represented a random sample of applications filed in the Cincinnati office over a particular time period. The vast majority were Forms 1023. Thirty-three (33) were merit closures; thirty-six (36) involved contacts with the applicant; and thirty-nine (39) were reviews of the advance ruling of public charity status, including a few mergers and terminations. A significant percentage (approximately 50%) of applicants were not represented by professional advisors (attorneys or accountants). The most common filing errors related to public charity classification, particularly with respect to the alternative public support tests under sections 509(a)(1) and 509(a)(2), followed by governing document insufficiencies. The Project Group review of the records revealed no incidents of case over-development and a surprising number of applications from churches<sup>7</sup>.

## **V. STEPS ALREADY TAKEN**

Throughout the entire determinations review process, the Project Group provided substantive input and advice to TE/GE regarding its ongoing efforts to improve the determinations process, and encourages TE/GE to continue these efforts, which are outlined in detail below.

*Form 1023 Revision Project.* The EO Determinations Customer Satisfaction Team has made significant progress in its Form 1023 revision project, with the ultimate goal of developing a more streamlined, comprehensive, efficient, and user-friendly

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<sup>7</sup> During 2002, approximately 4,400 exemption applications were filed by churches, which under section 508(c)(1)(A) are not required to file applications for exemption.

instrument for evaluating the qualification of applicant organizations for exemption under section 501(c)(3). Noteworthy improvements have been made in the area of streamlining by integrating several formerly separate forms, e.g., Form 872-C (Consent Fixing Period of Limitations), and Form 8718 (User Fee) into the Form 1023. Questions have been rearranged to flow in a more logical sequence. Other questions have been revised to elicit more useful information or have been eliminated. The Form 1023 instructions have been modified to provide more useful, easily-understood information.

The Project Group provided substantive comments on the Form 1023 revision project, and encourages the Customer Satisfaction Team to continue its efforts on the Form 1023 revision project, e.g., incorporating additional forms such as Form 2848 (Power of Attorney), Form SS-4 (Application for Employer Identification Number), and Form 5768 (Section 501(h) Lobbying Election), into the Form 1023, or the Form 1023 package; taking steps to ensure that organizations do not end up with two employer identification numbers ("EIN") -- one applied for by the organization prior to filing its Form 1023, and another assigned when its application is processed -- by requiring an EIN before a Form 1023 is processed and making EINs available by e-mail or telephone; as well as other appropriate modifications as suggested by various commenters.

In October 2002, IRS solicited comments on its proposed revisions to Form 1023<sup>8</sup>, and in early December 2002, received comments from approximately 50 submitters, including the ABA Section of Taxation Exempt Organizations Committee and the American Institute of Certified Public Accountants<sup>9</sup>. The Project Group acknowledges the challenges faced by the Customer Satisfaction Team as it attempts to reconcile the frequently contradictory suggestions made by various commenters. The overall goal of the Form 1023 revision project should be production of a technically accurate, simplified application package that solicits relevant information in a manner that minimizes additional, time-consuming contacts between determination specialists and applicant organizations.

*Determination Letter Revision Project.* The Customer Satisfaction Team has also made significant progress in its determination letter revision project. The batch of letters released in the first phase of the project met the Team's goal to produce more user-friendly, informative, flexible, and consistent determination letters. The Project Group has provided substantive comments on the determination letter revision project. Among the issues addressed by the Customer Satisfaction Team were inconsistencies in the form letters originating at the Cincinnati and Washington offices, and the need for more flexibility to incorporate customized paragraphs in unusual situations. The need to simplify the determination letter was addressed by placing essential exemption information in the body of the determination letter and using plain language attachments that contain important general information about the exempt organization's ongoing

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<sup>8</sup> Announcement 2002-92, 2002-41 I.R.B. 709 (October 15, 2002).

<sup>9</sup> These comments were published in the January/February 2003 edition of Paul Streckfus' EO Tax Journal.

obligations. This will enable an exempt organization to retain its determination letter in a safe place, while filing the attachments in its operational files for future reference.

*Educational Initiatives.* Roberta Zarin, Director, Customer Education and Outreach (“CE & O”), has initiated a series of one-day workshops for small and mid-sized tax exempt organizations, which covers topics such as exemption and filing requirements, unrelated business income tax, public inspection and disclosure of information returns, employment taxes, gaming activities, and the audit process. These workshops are designed for board members, officers and staff of exempt organizations that have received exemption within the last five years and have annual income of less than \$1 million. Workshops held during 2002 were surprisingly well attended, and confirmed that many smaller exempt organizations are not represented by professional advisors. The popularity of these workshops underlines the hunger for sound, basic advice in the exempt organizations community. Workshops have been scheduled in 12 cities (three one-day workshops in each city) from January through June 2003. In addition, CE & O is developing a “How to Apply for Tax-Exempt Status” workshop in collaboration with state charity officials. This four-hour, hands-on workshop will use a combination of lectures and exercises to address key application stumbling blocks, such as incomplete governing documents, the basics of private benefit, inurement and the adoption of a conflict of interest policy, foundation classification, and preparation of a budget. The workshop will be launched as a pilot at the six IRS nationwide tax forums. Participants in the tax forums are primarily enrolled agents and sole-practitioner CPAs, who are unskilled in EO filings. The Project Group commends these efforts, particularly the development of Form 1023-specific programs.

*TE/GE Call Site.* Often an exempt organization’s first contact with TE/GE involves a call to its Customer Account Services Call Site [1-877-829-5500]. Sophisticated EO practitioners are also familiar with the value of the Call Site and use it frequently. During 2002, the Call Site received 508,000 calls, of which 80 percent were exempt organizations inquiries. The Call Site anticipates receiving 620,000 calls during 2003. Ten (10) additional Call Site staff will be added in 2004, 7 of which will be from the EO function. Increased utilization of the Call Site derives in part from the excellent responsiveness of Call Site staff, who have access to helpful computer data, e.g., whether and when an applicant organization has been assigned to a determination specialist.

The contributions of the Call Site in the determinations process cannot be underestimated. The provision of accurate information and direction, particularly at the pre-application stage, can result in more expeditious application processing, an increase in the percentage of applications that are merit closures, and fewer and less intrusive subsequent contacts between applications and determination specialists. Efforts should continue to be made to provide Call Site staff with the most comprehensive, up-to-date information to facilitate responses to EO inquiries. Call Site staff should refer EO callers to the Life Cycle of a Public Charity and Life Cycle of a Private Foundation webpages, once they are posted on the IRS website.

Case Assignment Guide Revision. In the past, agents working as determination specialists operated within a grade level structure that was lower than that applicable to agents working in the examinations function, making retention of qualified personnel on the determination side problematic. Grade level structure is based in part on the EO case assignment guide (“CAG”), which was established in 1978 and had not been updated until recently. The CAG establishes broad issue categories, and within each issue category identifies cases as grade 11, grade 12, or grade 13 based upon specific sub-issues presented. Cases are given a preliminary grade upon intake, but final grading is not accomplished until closure, when a full evaluation can be made. Case grading is based on a range of factors including factual complexity, analytical complexity, application of the tax law, interpersonal factors (e.g., media exposure), projected impact of the application (e.g., national, regional, or local), and importance of the issues presented.

During 2003, realignment in grade structure between the determinations function and examinations function has been achieved<sup>10</sup>, as a positive byproduct of the revision of the CAG. This process has resulted in several promotion opportunities within the determinations function. The Project Group commends TE/GE for having pursued this solution and believes that the achievement of grade parity between the determinations and examinations functions within EO should result in enhanced longevity and experience of determination specialists, with concomitant increases in quality, efficiency and productivity.

Tax-Exempt Determination System. During 2003, authorization was obtained to implement the Tax-Exempt Determination System (“TEDS”) and the electronic imaging of Forms 1023. Implementation of TEDS will achieve efficiencies in grading and assignment of cases, particularly to determination specialists located outside of Cincinnati, and in developing statistics, analyzing issue trends, etc. Application processing time should decrease because fewer people will be involved in physically handling each Form 1023. While still not as advanced technologically as it should be, TEDS should improve the tracking of applications and expedite their release to the public until more advanced technology can be acquired and implemented.

Observation: The Project Group encourages increased coordination and information sharing within the EO function nationwide. Such coordination between all EO functions in Washington, Cincinnati, and various field offices is vital to the integrity of the determinations process. Both formal and informal mechanisms of information sharing among the Washington, Cincinnati and other field offices within the Rulings and Agreements function already exist, and consistent training is currently provided either in Cincinnati or at various field offices. Additional means of coordination and information sharing might include regular, ongoing training updates by means of internal broadcast e-mail or similar means; internal listservs or regional practice groups to pose questions,

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<sup>10</sup> The realignment achieved parity in the grade progressions for both the determinations and examinations functions. Parity does not exist with respect to the number of slots at each grade level, which reflects the increased complexity of cases in the examinations function.

discuss emerging trends, and share insights on case development; regular rotations among the Washington, Cincinnati, and various field offices; and prompt sharing of new information and emerging EO trends with the TE/GE Call Site. Closer coordination would encourage more trend analysis and quicker attention to emerging issue areas, e.g., web-based exempt organizations.

## **VI. RECOMMENDATIONS**

The Project Group considered information, comments and suggestions gathered from interviews with practitioners, press, and IRS representatives, from comments offered at the ABA meeting and submitted as part of the Form 1023 revision process, and from reviewing selected application records, as well as from their own experience and observations.

The ACT previously recommended installation of the Life Cycle of a Public Charity and Life Cycle of a Private Foundation<sup>11</sup> webpages on the IRS website as a means of providing access to narrative explanations and applicable forms and instructions relating to significant events in the “life” of a charity. The Project Group presents below a range of recommendations with respect to the determinations process, many of which are logical extensions of the ACT’s earlier Life Cycle recommendation, and follow upon the steps that have already been initiated within TE/GE.

**Recommendation #1: Develop Fully Interactive Form 1023.** The Project Group recommends that TE/GE continue efforts to develop and fund a fully interactive Form 1023 (“CyberAssistant”) that will be posted on the IRS website and integrated with the IRS Life Cycle webpages.

**Observation:** In addition to serving as the instrument whereby eligibility for recognition of section 501(c)(3) exemption is determined, Form 1023 and its accompanying instructions serve an important educational function for exempt organizations, the significant majority of which are not represented by experienced advisors. In addition to the exemption determination letter, the Form 1023 is a principal source of information about an organization’s ongoing obligations with respect to maintaining exempt status.

The majority of Form 1023 filers are one- or two-time filers, whether they are organization volunteers, local practitioners or practitioners providing services through pro bono agencies. Information to assist these filers is available through IRS publications, the IRS website, and the Call Site. In addition, the needs of these filers are being addressed by an emerging industry in EO “how to” books and websites. The

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<sup>11</sup> These recommendations were made at the ACT public meeting held in Washington, DC on June 21, 2002, the report of which is found on the EO website, [www.irs.gov/eo](http://www.irs.gov/eo).

high attendance at the CE & O workshops indicates that more can and should be done to educate these filers.

CyberAssistant, the fully interactive Form 1023 posted on the IRS website, could guide an applicant organization through the Form 1023, explaining the need for and relevance of particular information, referring and linking to relevant IRS publications, defining essential and unfamiliar terms, and relating coordinated sections of Form 1023 to one another. By providing this background information, CyberAssistant would be able to eliminate “gotcha” aspects of certain Form 1023 questions for novice applicants, and identify circumstances in which an applicant does not qualify for exemption. For example, a “yes” answer to a question about political campaign intervention would result in pop-up advice from CyberAssistant that the organization is disqualified from section 501(c)(3) status, and a suggestion either to eliminate the activity or consider section 501(c)(4) status, with links to appropriate additional information and forms.

CyberAssistant could also provide practical pop-up advice, (e.g., that having the word “foundation” in an organization’s name doesn’t make it a private foundation), checklists, decision trees for key issues (e.g., choosing among various public charity categories), prompts, and question-series designed to assist applicants in completing Form 1023. In a fully interactive format, CyberAssistant could include a dedicated e-mail feature whereby applicants would be able to pose questions and receive answers as they encounter snags or obstacles in completing Form 1023. An applicant could download and print the completed Form 1023 and mail it to IRS, or e-file it directly. “Fail safe” features could be installed to prevent the applicant from providing inconsistent responses or printing a Form 1023 that lacked essential information.

*Comments:* The benefits of a fully interactive Form 1023 are obvious and significant. In addition to providing essential technical information to applicants, CyberAssistant will provide practical guidance that will enable applicants to avoid the most common pitfalls resulting in unnecessary application delays. The Project Group anticipates that implementation of CyberAssistant will increase the quality of Form 1023 submissions, and will result in a marked increase in the percentage of applications that will qualify for merit closure without the need for additional contact between the applicant organization and determination specialist. Further, based on discussions with TE/GE representatives, the Project Group anticipates that the implementation of CyberAssistant can be funded as a later phase of the TEDS process. In addition, elements of the technology developed for the TE/GE Form 990 e-filing and Section 527 e-filing initiatives may be transferable to a CyberAssistant project.

**Recommendation #2: Develop Fully e-Fileable Form 1023.** The Project Group recommends that TE/GE continue its efforts to develop and fund a fully e-fileable Form 1023 that will be posted on the IRS website and integrated with the IRS Life Cycle webpages and CyberAssistant.

Observation: Development of a fully e-fileable Form 1023 would save significant time in mailing, processing, assigning and developing applications. Further, TE/GE would be able to more easily track applications, isolate specific application characteristics and trends, sort applications for data analysis, statistical, and compliance purposes, and more efficiently make applications available to the public.

Comment: Protocols would need to be developed relating to the acceptance of electronic signatures, applicant privacy, and verification of organizing documents that cannot be provided electronically.

**Recommendation #3: Facilitate Development of Form 1023 Database.** The Project Group recommends that, as Forms 1023 are electronically imaged or filed, TE/GE facilitate development of a database of completed Forms 1023 that will be searchable by type of organization, state of location, and other relevant parameters.

Observation: Forms 1023 are subject to public disclosure, but are not available online. Currently, the Guidestar website [www.guidestar.org] provides imaged Forms 990 that are available to all segments of the public, including contributors, government officials, members of the press, and EO advisors. The easy public access to these Forms 990 has been extremely beneficial. Among other things, Forms 990 can provide EO advisors with a source of useful information and ideas for filing Forms 1023.

Comment: Easy public access to Forms 1023 would provide a better source of useful information regarding the type of organizations that qualify for exemption under section 501(c)(3). Among other things, these Forms 1023 could be used as models for applicant organizations, particularly organizations not represented by experienced advisors.

**Recommendation # 4: Develop Prominent Form 1023 “Helpful Hints” Checklist.** The Project Group recommends that a prominent checklist of “helpful hints” be added to the Form 1023 application package. This checklist should include: all required documentation; clear instructions to insure that the organization’s name on the application is the same as the name on the governing document; the order in which forms, documents, and user fee check must be arranged; the need to pay the user fee by certified check in order to avoid a mandatory 30-day check-holding period; and similar items designed to expedite application processing time and increase the likelihood that the application can be closed on a merit closure basis.

Observation: A significant percentage of exemption applications are filed without benefit of legal or other professional advisor. Even when an application is filed with the assistance of a professional advisor, frequently the advisor is not an EO specialist, and may be providing pro bono or first-time EO assistance. Non-represented applicants and non-frequent-filer practitioners are more likely to be unfamiliar with the law and application procedures, and thus submit incomplete or unclear applications that require

additional, sometimes repetitive contacts by determination specialists, resulting in processing delays or failures to establish exemption.

*Comment:* There are a number of “helpful hints”, known to frequent-filer practitioners, but often overlooked by first-time and unrepresented Form 1023 filers, which could be developed into a checklist as a means of reducing unnecessary delays and repetitive contacts with determination specialists. Requiring the checklist to be submitted with the application or providing expedited treatment for applications submitting the checklist would encourage its use. The Project Group anticipates that use of this checklist will increase the number of applicants filed by first-time and unrepresented filers that will qualify for closure on a merit basis.

**Recommendation # 5: Conform Two Public Support Tests.** The Project Group recommends that the two existing public support tests in sections 509(a)(1) and 509(a)(2) be conformed with a consistent support definition, appropriate qualification threshold, consistent 2 percent limitation, alternative facts-and-circumstances test, and clear instructions regarding the steps an organization must take when it falls below the minimum standards for qualification under either test.

*Observation:* All section 501(c)(3) organizations are either public charities or private foundations. Different rules apply for each classification. There are several methods whereby an organization can establish that it is a public charity (the more favored classification), based on type of organization, sources of support, or relationship to other organizations. Classification as a public charity or private foundation is perhaps the single most confusing concept for section 501(c)(3) applicants, including those represented by non-frequent-filer practitioners.

Adding to the general confusion is the fact that there are two alternative “public support” tests for establishing public charity status under sections 509(a)(1) and 509(a)(2)<sup>12</sup>. Briefly, the section 509(a)(1) public support test applies to organizations that normally (on a rolling 4-year basis) receive at least one-third of their total support from governmental units, from contributions made directly or indirectly by the general public, or from a combination of these sources. The section 509(a)(2) public support test applies to organizations that normally receive more than one-third of their support from any combination of gifts, grants, contributions, membership fees and gross receipts from exempt activities, and that normally receive no more than one-third of their support from gross investment income and the net unrelated business income.

The inherent confusion created by two alternative public support tests is exacerbated by the fact that different standards and definitions apply within each test. For example, an organization failing to meet the section 509(a)(1) one-third test may qualify under a facts-and-circumstances test, provided that it normally receives 10

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<sup>12</sup> As of the end of 2002, there were 501,268 section 509(a)(1) publicly supported organizations, and 223,731 section 509(a)(2) publicly supported organizations.

percent of its support from approved sources. There is no corresponding facts-and-circumstances test under section 509(a)(2). There are different definitions of support under the section 509(a)(1) and section 509(a)(2) public support tests, and different limitations in the computation of support received from a single source, generally 2 percent from a single donor for section 509(a)(1) and \$5,000 or 1 percent for section 509(a)(2). Further, government support is considered “public” with no limitation under the section 509(a)(1) test, but is subject to the \$5,000/1 percent limitation under section 509(a)(2). Section 509(a)(2) also excludes all support from disqualified persons, whereas section 509(a)(1) merely subjects such support to the 2 percent limitation. Finally, there are limitations on the amount of investment and unrelated business income permitted for section 509(a)(2) organizations, but not for section 509(a)(1) organizations.

*Comment:* Any original rationale<sup>13</sup> for the development and maintenance of complex standards under two different public support tests is today outweighed by the need for increased simplicity, consistency, and efficiency in the administration of the public support tests. Conforming and simplifying the two alternative public support tests would ameliorate a significant source of confusion for applicant organizations and their representatives, and would thereby simplify the application review process. The Project Group also urges interested stakeholders to consider the benefits, drawbacks, and mechanics of combining the two existing support tests in sections 509(a)(1) and 509(a)(2) into a single, coherent test, and whether such a combined support test would represent a significant improvement over the recommendation for key conforming changes in the two existing tests<sup>14</sup>.

**Recommendation # 6: Eliminate Form 8734 at End of Advance Ruling Period.** The Project Group recommends elimination of Form 8734 at the end of the advance ruling period for publicly supported organizations. Instead, the final determination of public support should be made on the basis of Schedule A to Form 990

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<sup>13</sup> Both the House and Senate Reports to the Tax Reform Act of 1969 (“TRA”) indicated a desire to exclude from the definition of private foundation four broad categories of organization: (1) organizations, contributions to which may be deducted to the extent of 30 percent [increased to 50 percent in TRA] of an individual’s income [509(a)(1)]; (2) certain types of broadly publicly-supported organizations (including membership organizations) [509(a)(2)]; organizations which are organized and operated exclusively for the benefit of one or more organizations described in (1) or (2), and are controlled by one or more organizations, or operated in connection with one organization described in (1) or (2); and (4) organizations which are organized and operated exclusively for testing for public safety. The House Report indicated that the type of organizations that would typically be classified under type (2) above include “symphony societies, garden clubs, alumni associations, Boy Scouts, Parent-Teachers Associations and many other membership organizations”. See H.Rep. 91-413, 91<sup>st</sup> Cong., 1<sup>st</sup> Sess., 1969-3 C.B. 226-227. The Senate report makes a clear distinction between type (1) broadly publicly supported organization and certain “other” type (2) organizations, but does not explain why the one-third limit on investment income, for example, is appropriate for type (2) organizations but not for type (1) organizations. See S. Rep. 91-552, 91<sup>st</sup> Cong., 1<sup>st</sup> Sess., 1969-3 C.B. 460-461.

<sup>14</sup> Replacing the two existing public support tests of section 509(a)(1) and 509(a)(2) would require legislative changes.

that would contain 5 years' financial data. The Project Group further recommends that the financial information requested on the Form 1023 and Form 990 be conformed.

*Observation:* Form 8734 must be completed at the end of the 5-year advance ruling period by newly-created organizations that claim public charity status under either of the two alternative public support tests of sections 509(a)(1) or 509(a)(2) and receive an advance ruling of such status. The advance ruling period and Form 8734 are a source of confusion for exempt organizations, many of which erroneously believe that Form 8734 requires them to re-establish their exempt status. Many new organizations deviate significantly from their sources of support as estimated in their Forms 1023. Further, the financial information requested on Form 8734 differs from the financial information required on Schedule A of Form 990<sup>15</sup>.

*Comment:* A definitive ruling of public charity status or private foundation status could be issued automatically at the end of the 5-year advance ruling period on the basis of the financial information provided on an organization's annual Form 990. Issuance of the definitive ruling could be the responsibility of the Ogden Service Center.

Thereafter, the computation of public support could be made automatically by the Ogden Service Center annually on the basis of information provided on the Form 990. Ogden could be responsible for notifying an organization of any change in status. Such a system of automatic support computation could eliminate the confusion experienced by section 509(a)(1) organizations that fall below the 10% threshold by informing them of their new private foundation status and filing instructions.

The fact that definitive rulings of public charity status are currently made in Cincinnati and Forms 990 are currently reviewed in Ogden should not pose an obstacle to implementation of this recommendation. Likewise, the fact that Schedule A currently requests 4-year financial data and definitive rulings of public charity status at the end of the advance ruling period require 5-year financial data should not prevent implementation of this recommendation.

At a minimum, electronic imaging of Form 990 with automatic tracking/computation of financial information for organizations coded under section 509(a)(1) or 509(a)(2) would be required before automatic computation of public support could be implemented. In addition, small organizations (below the \$25,000 filing threshold) and any other publicly supported organization not required to file Form 990, e.g., an integrated auxiliary of a church, would not be tracked for compliance.

**Recommendation # 7: Specify Section 509(a)(3) Test in Form 1023 and in Determination Letter.** The Project Group recommends that Form 1023 be revised to require applicants seeking public charity classification as section 509(a)(3) supporting organizations specify the particular test ("operated, supervised or controlled by",

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<sup>15</sup> A current EO project is addressing this situation.

“supervised or controlled in connection with”, or “operated in connection with”) under which they intend to qualify. The Project Group further recommends that determination letters issued to section 509(a)(3) supporting organizations specify the particular test under which they have qualified for section 509(a)(3) status<sup>16</sup>.

**Observation:** One essential piece of information included in an organization’s initial determination letter is its specific public charity classification. Currently, the initial determination letter indicates that an organization qualifies for public charity classification as a supporting organization under section 509(a)(3), but fails to specify under which of the three supporting organization tests the organization qualifies.

**Comment:** Awareness of the specific section 509(a)(3) test (“operated, supervised or controlled by”, “supervised or controlled in connection with”, or “operated in connection with”) under which an organization qualifies is essential for initial compliance. Although Schedule D of Form 1023 (revised draft) requests information regarding the three section 509(a)(3) tests, the applicant organization is not required to specify which test it intends to meet. Amending Schedule D to request this information will require the applicant organization to focus on the requirements of the particular test selected, and increase the likelihood that the requirements of that test will be met. This will in turn reduce subsequent contacts between the applicant organization and the determination specialist.

Awareness of the specific section 509(a)(3) test under which an organization qualified as a public charity is also necessary for ongoing compliance. Although the specific test may have been known to an organization’s initial board of directors, with the passage of time this information is often lost to subsequent boards, legal counsel or accountants. Including this information in the initial determination letter will preserve it for future reference and will increase the likelihood of compliance with the requirements of the particular test on an ongoing basis.

**Recommendation # 8: Develop Standard Public Charity Reclassification Process.** The Project Group recommends development of a convenient, standardized public charity reclassification process, whereby an existing public charity can report relevant changes in activities or support, and obtain a revised determination letter reflecting its new public charity status or its reclassification as a private foundation.

**Observation:** At the time of filing Form 1023, many newly-created organizations are not able to predict accurately their actual activities or sources of support. Thus, it is not unusual for an organization to receive an initial classification of public charity status that several years into its operations is no longer appropriate. In addition, even established public charities may decide to modify their operations or sources of support in a manner that would result in a reclassification of their public charity status into a different public charity category or private foundation status. Organizations may report these changes in activities and support on their Form 990s, but there is no clearly-

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<sup>16</sup> As of the end of 2002, there were 29,843 section 509(a)(3) supporting organizations.

defined process for requesting reclassification of public charity status. There can be serious consequences for organizations that continue to operate as public charities when they are properly classified as private foundations, e.g., liability for excise tax under section 4940 and potential self-dealing problems under section 4941.

**Comment:** A standardized system for reclassification of public charity status is needed whether IRS retains or eliminates Form 8734. Currently, exempt organizations and their advisors have no clear guidance on the appropriate action to take when circumstances result in a change in public charity status. They don't know what to send, where or to whom. Experienced advisors have developed their own ad hoc systems for writing to Cincinnati, but most organizations erroneously expect that any change in public charity status will be noted and implemented automatically on the basis of the filing of Form 990 with the Ogden Service Center. The 60-month termination process for private foundations seeking reclassification as public charities is an appropriate prototype, albeit for the reverse situation.

**Recommendation # 9: Develop Standard, "One-Stop" Name-Change Process.** The Project Group recommends the development of a convenient, standardized process, whereby an exempt organization can report a name change and obtain a revised determination letter reflecting the organization's new name. This should be a one-stop process, enabling the organization to record its name change for all necessary purposes, e.g., Exempt Organizations Business Master File, EIN, Publication 78, employment tax accounts, etc.

**Observation:** It is not unusual for an exempt organization to change its name during the course of its existence to reflect a new location, change in emphasis or activities, or change in relationship to another organization. Such name changes are currently reported to IRS on Form 990 or in separate correspondence. However, there is no clearly-defined process for reporting changes in organizational name or obtaining a revised determination letter reflecting the new name<sup>17</sup>.

**Comment:** As a result, an organization may spend needless time and effort convincing donors, foundations, state charity and tax officials, and others that it is, in fact, the same organization as the organization to which its IRS determination letter was originally issued and which is listed in Publication 78..

**Recommendation # 10: Link IRS Website to State Charity Officials Website.** The Project Group recommends that the IRS website include links to state charity officials, through the Life Cycle webpages and through the CyberAssistant interactive Form 1023 (when implemented), beginning with the NAAG/NASCO website

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<sup>17</sup> Form 8822 exists for recording a change of address for employment, excise, income, and other business returns, but this form does not address organization name changes for returns and publications specific to exempt organizations.

[www.nasconet.org], which contains links to various state charity officials' websites. In the future, direct links to various state websites should be added, as part of a "Where are you located?" assistance prompt that could lead applicants to information about state incorporation, registration, charitable solicitation, and other useful information.

**Observation:** When the ACT-recommended Life Cycle webpages are posted on the IRS website, they will include information on charitable solicitation, with links to sites that provide state charitable registration requirements.

**Comment:** In order to maximize their usefulness, the Life Cycle webpages need to be reviewed regularly and enhanced as additional information useful to exempt organizations becomes available online.

## **VII. CONCEPTS FOR FURTHER CONSIDERATION**

The Project Group gave thorough consideration to all recommendations developed by interviewees and other participants throughout the determinations review process. In addition to its 10 recommendations detailed above, the Project Group also identified several concepts for improving or revising the determinations process that were not recommended. In the interest of completeness, and to stimulate further discussion and development among interested stakeholders, the Project Group presents these concepts below.

**Concept A: Increase Form 1023 Filing Threshold.** The current Form 1023 filing threshold, established in section 508(c)(1)(B) is \$5,000. Increasing this threshold would eliminate the need for review of the applications of the smallest organizations, many of which can be expected to go out of existence within the first few years. For example, conforming the Form 1023 filing threshold to the Form 990 filing threshold (currently \$25,000) could, in addition to eliminating confusion and enhancing consistency in EO filing requirements<sup>18</sup>, free up determination specialists for more consequential application review, and reduce "deadwood" listings on the Exempt Organizations Business Master File<sup>19</sup>. IRS might also explore whether there are other discrete categories of organization for which filing Form 1023 is unnecessary in the efficient administration of the tax law.

**Comment:** Abuses can occur in small organizations as well as large organizations. One of the benefits of the Form 1023 process is its virtual universality. The initial application review provides IRS a unique opportunity to eliminate unqualified

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<sup>18</sup> The initial Form 990 threshold was also \$5,000 until it was increased by discretionary authority of the Secretary of the Treasury; see Announcement 82-88, 1982-25 I.R.B. 23. Presumably, the same discretionary authority could be used to increase the Form 1023 filing requirement under the rubric of section 508(c)(2)(B).

<sup>19</sup> The EOBFM currently lists many small organizations that are no longer in existence, because the organizations never informed IRS of their terminations.

organizations. Raising the threshold to \$25,000 would permit unqualified or abusive organizations to operate under the IRS radar screen. In addition, since most organizations need the IRS determination letter in order to assure deductibility of contributions, it is not clear that raising the filing threshold would eliminate a significant number of applications. Finally, the Form 1023 serves an educative function, by informing organizations of the basic requirements for maintaining exempt status, which would be lost to smaller organizations if the Form 1023 filing threshold were increased.

**Concept B: Adopt Registration System with Operational Follow-Up.** Many organizations filing Form 1023 are new organizations that are unable to provide definitive information about their activities or sources of support. It has been suggested that too much emphasis is placed on the initial determination of exempt status, which is frequently based on proposed, anticipated, or conjectural activities and sources of support. Although sources of support are reviewed after 5 years for organizations receiving advance rulings as publicly supported organizations, this process does not involve an operational review. It has been recommended that Form 1023 be eliminated completely, in favor of a simple postcard registration system whereby organizations could provide basic identifying information, self-select public charity status, and certify that basic criteria for section 501(c)(3) status are satisfied, e.g., private benefit, inurement, lobbying, political activity<sup>20</sup>. By eliminating the initial determination, EO personnel could focus on compliance, by means of a full operational review at 3-year, 5-year or some other appropriate interval after initial registration.

**Comment:** The opportunities for abuse are obvious and significant. Organizations would have an unfettered “free ride” in which to enjoy the benefits of exemption and deductible contributions during the period from initial registration until subsequent compliance review. Unscrupulous individuals could divert significant funds during a five-year period. If an organization were to go out of existence before any compliance review could take place, there would be no easy means of correction. Even well-intentioned organizations could be certifying to section 501(c)(3) requirements and public charity status that they do not understand. Finally, at current levels, EO would lack the staffing necessary to undertake 88,000 (based on current application levels) operational reviews annually.

**Concept C: Develop Separate Form 1023-PF.** Organizations that are private foundations present unique and complex issues not relevant to public charities.

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<sup>20</sup> Interestingly, the version of the CARE bill currently under consideration by the Congress includes a provision that would require small organizations that are excused from filing Form 990 because they do not meet the \$25,000 filing threshold to file a short annual notice in order to enable IRS to maintain a record of the continuing existence of these organizations and to permit the public more easily to obtain basic information about them. This annual notice would include the legal name of the organization, any name under which it operates or does business, the organization’s mailing address and Internet website address, its taxpayer identification number, the name and address of a principal officer, and evidence of the organization’s continuing basis for exemption from the Form 990 filing requirement. Failure to file the annual notice for three consecutive years would result in revocation of exemption, with the obligation to file Form 1023 in order to re-establish exemption.

Advisors who represent organizations that wish to be classified as private foundations have suggested the development of a separate Form 1023-PF that would more quickly and fully develop issues relevant to that status.

*Comment:* Basic exemption qualification criteria are shared by both public charities and private foundations. A relatively small percentage of information solicited in the current Form 1023 (draft revision) relates solely to private foundations. A separate application for private foundations could help isolate classification issues for novice applicants, and could be processed more quickly. However, these potential benefits are offset by the risk that the Form 1023-PF would be submitted by organizations that are actually public charities. An inexperienced submitter could make this error for a number reasons, e.g. the word “foundation” in an organization’s name.

**Concept D: Develop Separate Form 1023-EZ.** It has been suggested that small organizations – either organizations below the current \$5,000 filing threshold that nonetheless wish to have an exemption determination letter for fundraising, or organizations below the \$25,000 Form 990 filing threshold – be permitted to file a Form 1023-EZ. This would be a simplified application that requested basic identification information, governing documents, a description of activities, and posed a series of questions to determine public charity status and potential disqualification for private benefit, inurement, lobbying and political activity.

*Comment:* There is actually very little “fat” in the current Form 1023 (revised draft). Most questions are necessary to a principled determination of eligibility for exemption under section 501(c)(3). Further, it is unclear what would happen when a small organization encounters a growth spurt, attracting additional funds and conducting expanded activities: should such an organization then be required to file the “full” Form 1023?

**Concept E: Institute Regular Operational Reviews.** Most organizations filing Form 1023 are new organizations that are unable to provide reliable information or predictions about their activities or sources of support. It has been suggested that TE/GE institute a regular system of operational reviews at 3-year, 5-year or some other appropriate interval after exemption is recognized. Such reviews could be conducted either on a random basis or on the basis of coding that would occur at the time of the initial determination letter. These reviews would not simply replicate the current review of financial information provided on Form 8734 for publicly supported organizations, but rather would focus on actual operations, charitable accomplishments, relationships with insiders, lobbying, and political activity, etc.

*Comment:* Information gathered from a system of 3-year, 5-year, etc., operational reviews could provide important statistical data, enhance trend analysis, identify organizations that have gone out of existence, and form the basis of future compliance efforts. Further, organizations’ awareness of the pendency of such an

operational review could serve a deterrent effect. However, such a program would require significantly increased staffing at a higher grade level, as the issues presented would be more complex than those presented upon initial application. It could not be accomplished within current EO staffing levels unless the initial Form 1023 review were eliminated.

**Concept F: Eliminate Form 1023 Filing for Certain Reincorporations.** From time to time, exempt organizations relocate from one state to another. In association with such an interstate move, an organization may elect to dissolve its corporation in the old state and incorporate as a new corporation in the new state in order to qualify as a domestic corporation. When an organization reincorporates under the laws of another state, it is considered by IRS to be a new legal entity. That new entity is required to refile Form 1023 even if its purposes, activities, and sources of support remain exactly the same.<sup>21</sup> An organization that merely relocates to another state without reincorporating is not required to file a new application. It has been suggested that the new application requirement be simplified or eliminated for exempt organizations that relocate and reincorporate in a new state without any other changes in purposes, activities, or sources of support.

**Comment:** Organizations reincorporate for many different reasons, among them, relocation to another state. It would be difficult to justify relieving only certain reincorporated organizations from the new Form 1023 application requirement. Without a new application, it would be difficult to ensure that no other material changes in purposes, activities, or sources of support had, in fact, been made. In addition, the new Form 1023 provides IRS an additional opportunity to ensure that the organization continues to meet the requirements of section 501(c)(3) and public charity status. However, a “new” organization reincorporating under these circumstances should be able to obtain a definitive public support ruling based on the financial data of the “old” organization.

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<sup>21</sup> See Rev. Rul. 67-390, 1967-2 C.B. 179.