NATIONAL COUNCIL OF NONPROFITS
National voice. State focus. Local impact.

May 28, 2021

Internal Revenue Service
Attn: CC:PA:LPD:PR (Notice 2021-28) Room 5203
P.O. Box 7604
Ben Franklin Station
Washington, D.C. 20224

Submitted Electronically

Re: Recommendation for the 2021-2022 Priority Guidance Plan Pursuant to Notice 2021-28

To whom it may concern:

On behalf of the National Council of Nonprofits ("Council of Nonprofits"), we submit the following recommendations for priority guidance for the Treasury Department and the Internal Revenue Service.

The Council of Nonprofits is the nation's largest network of nonprofits, with more than 25,000 organizational members throughout the country. Our membership reflects the wide spectrum of charitable nonprofit missions. The recommendations presented here focus on issues of concern to nonprofit organizations as well as the millions of taxpayers who support such organizations with both financial contributions and volunteer service. We offer these recommendations in the spirit of ensuring a robust charitable sector that enjoys the confidence and support of the general public and promoting sound tax administration and compliance.

In these comments, we recommend that the Treasury Department and the Internal Revenue Service address the following topics in the Priority Guidance Plan:

I. Revise significantly or abandon completely the current Form 1023-EZ and processing of the so-called "Streamlined Application" for tax-exempt status (**High Priority**);

II. Issue a revenue procedure for the calculation of "gross receipts" for nonprofits for purposes of qualifying for the Employee Retention Credit under the decline in gross receipts test and specifically state that such receipts should not include the forgivable amount of Paycheck Protection Program loans (**High Priority**); and

III. Clarify Form 990 instructions to assure more accurate reporting of revenues earned from government grants and contracts for services (**Medium Priority**).

I. Significantly revise or abandon completely the current Form 1023-EZ

Until 2014, the IRS required all groups seeking charitable tax-exempt status to file a common application, Form 1023, which served multiple purposes. Applicants had to attach copies of their state formation documents and bylaws, thereby proving their legal existence and purpose. They also had to perform certain tasks to complete Form 1023, such as preparing a three-year statement of revenues and expenses, which had the benefit of exposing them to the unique legal and operational requirements for charitable nonprofits (such as limitations on activities, compensation, and use of charitable assets). The application process played at least two important deterrent roles: weeding

out those who thought it would be a quick way to get easy money and putting applicants on notice about accountability.[1]

In 2014, IRS introduced Form 1023-EZ, Streamlined Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code ("Streamlined Application") for the stated purpose of increasing efficiencies in processing to address an ever-increasing backlog of tax-exempt applications. The IRS did so despite significant objections and recommendations of experts on its Advisory Committee on Tax Exempt and Government Entities, its state regulatory partners with the National Association of State Charities Officials, and practitioners in the charitable community, including the National Council of Nonprofits and various accountants.

Now, a person can use the Form 1023-EZ to secure tax-exempt status for an entity merely by claiming everything is accurate, that the applicant's total assets do not exceed $250,000, and its annual gross receipts will not exceed $50,000 in either the past 3 years or projected for any of the next 3 years. The result of this bare attestation is the significant benefit of federal income tax exemption – and thereby state and local income and property tax exemptions. In contrast, the standard Form 1023 requires submission of numerous schedules and over 50 specific requests for additional information or backup materials as proof.

Although the Streamlined Application clearly cuts down on the paperwork requirements on newly created charitable nonprofits (and enables the IRS to process such applications in less time), this efficiency has produced alarming results. Various government bodies and tax policy experts have warned that the current Form 1023-EZ provides neither sufficient guidance to the prospective organization nor adequate proof or information to the IRS as to whether an organization truly exists or is actually organized in a manner that satisfies the requirements of Internal Revenue Code Section 501(c)(3).

Numerous studies by the U.S. Government Accountability Office, as well as reports issued by the IRS' National Taxpayer Advocate, which has conducted four extensive audits of the use of Form 1023-EZ, have subjected the Streamlined Application to significant criticism and consistently found that the IRS has erroneously approved ineligible applicants at astonishingly high rates: 37 percent (2015), 26 percent (2016), 42 percent (2017), and 46 percent (2019).[2] This consistent and unacceptably high error rate, combined with the lack of subsequent entity audit or review, as initially promised by IRS commissioners, produces "a meaningless tax-exempt application process and a toothless monitoring regime, a combination resulting in thousands of unworthy entities enjoying charitable status," according to analysis by a prominent tax law professor. He went on to predict, "If this widespread

[1] "The level of detail on Form 1023 is also helpful in signaling to applicants that they are entering into a complex regulatory environment with a strict set of rules. While most people who establish a new charity are good people and want to do good things, the thoroughness of Form 1023 helps underscore that tax exemption is a privilege that comes with responsibilities." Internal Revenue Service, Advisory Committee on Tax Exempt and Governmental Entities (ACT): Report of Recommendations (Rev. 06-2012) Publication 4344: Catalog Number 38578D, at 87 (June 6, 2012).

[2] See, e.g., U.S. Government Accountability Office, GAO-15-164, *Tax-Exempt Organizations: Better Compliance Indicators and Data, and More Collaboration with State Regulators Would Strengthen Oversight of Charitable Organizations*, December 2014; Taxpayer Advocate Service, 2015 Annual Report to Congress, Volume One, p.36; Taxpayer Advocate Service, Fiscal Year 2020 Objectives Report to Congress, Section Four, p. 92.

noncompliance continues unabated, it will decimate the public's confidence in the entire charitable sector."[3]

We are not suggesting in any way that every entity wrongly approved is a crook or bad actor. Nor are we suggesting that IRS officials and employees do not care. But there is widespread concern about charitable nonprofits losing the public's trust if people do not have confidence in the ability of law enforcement to protect the public from fraudsters masquerading as legitimate nonprofits.

It should be noted that many so-called small charitable nonprofits (those with less than $50,000 in gross receipts) can also file an abbreviated annual report Form 990-N which does not require disclosure of financial information, salaries of key employees, or any detailed description of charitable activities. When combined, Form 1023-EZ and Form 990-N provide little of the information the public needs to evaluate and monitor the activities of entities eligible to generate tax-deductible donations. Stated more bluntly, the two forms required donors to rely on "blind faith" that the organizations seeking their gifts are who they say they are and spend those donations legally and appropriately.

Charitable nonprofits have long recognized that a rigorous application process plays an essential role in the education of the prospective organization to help ensure understanding and compliance with the duties and responsibilities of the tax-exempt sector. By relieving applicants from completing detailed narratives of the organization's past and future activities, the Streamlined Application eschews any critical evaluation of how the organization fulfills its charitable purpose. Similarly, the lack of detailed financial information robs the organization of thoughtful consideration as to how much charitable activities might cost and how the organization will raise the needed funding. The instructions to the Streamlined Application provide only limited information about what is necessary to operate consistent with charitable status under code section 501(c)(3), and even then the applicant is not required to identify specifics about its operations.

In short, applicants can merely check boxes on the EZ form to secure tax-exempt status without knowing or caring what tax-exempt status actually entails. This is an extreme disservice to the donating and volunteering public, to state charities enforcement and oversight officials, and to the vast majority of charitable organizations dedicated to upholding the law and promoting their missions for the public good.

Recommendation: We urge the IRS during the upcoming priority guidance period either to make significant modifications to the current Form 1023 EZ Streamlined Application or to require all applicants to complete Form 1023. Our specific recommendations for modifications include the following:

1. **Require detailed information regarding the organizational activities of the applicant.** Because the current Streamlined Application does not require the submission of organizational documents, there is no way for the IRS to adequately determine statutory compliance with the requirements of Section 501(c)(3). Satisfaction of the organizational test, as demonstrated by the organizational documents, is the prerequisite for meeting the statutory definition for charitable status. Such documents limit the organization's

[3] Eric Franklin Amarante, *Unregulated Charities*, 94 Wash. Law R. 1503 (2019).

purpose to those permitted by Section 501(c)(3) and must not expressly empower it to engage, other than as an insubstantial part of its activities, in activities that are not in furtherance of one or more of the enumerated purposes. Such documents should also provide information as to the organization's non-distribution constraint as well as the dissolution clause, which regulates how assets are distributed should the organization cease operations.

2. **Require current basic financial data as well as projections for three future years.** As noted above, the Streamlined Application does not require any financial data other than an attestation of qualification. Combined with the potential for annual compliance with filing Form 990-N, this results in the lack of any financial information regarding charitable operations. Such a "check-the-box" approach deprives the public, prospective donors, and volunteers of sufficient information regarding the organization, greatly inhibiting informed decisions and potential lack of faith in the charitable sector.

We note that state law currently dictates the requirements for formation and governance of charitable nonprofits and that all states require incorporation to form a nonprofit corporation. The instructions for Form 1023 require that a corporation must be incorporated under the nonprofit or nonstock laws of the jurisdiction in which it incorporates. A recent examination of selected state nonprofit incorporation statutes and requirements demonstrates that although states have different formation procedures, several state statutes currently require the submission of information to satisfy recommendations #1 and #2 above. We urge the IRS to consider requiring a uniform approach in the application process and adopt the information disclosures as outlined in such recommendations.[4]

In support of this recommendation, we recognize that the IRS recently issued a memorandum that "updates procedures for processing Form 1023-EZ" and incorporates a similar solution in cases where additional information is needed to process the exemption application. The memorandum instructs IRS personnel to "[s]end Letter 1312, Request for Additional Information, to request the organizing document (if unable to print from state website or secure from prior application), a more detailed description of activities, financial information, and details regarding specific activities indicated in Part III of Form 1023-EZ."[5] We believe strongly that continuous updates to the field are no substitute for conducting a thorough re-evaluation and fundamental repair of the application process.

In the past, the Council of Nonprofits has recommended that the IRS withdraw the current Streamlined Application and engage stakeholders in a process to develop a workable replacement.

[4] For a more detailed examination of state statutes and regulations that can help assure that newly formed charitable nonprofits satisfy regulatory compliance with the provisions of Section 5019(c)(3), see generally Eric Franklin Amarante, *States as Laboratories for Charitable Compliance: An Empirical Study,* The University of Tennessee College of Law Legal Studies Research Paper Series, Research Paper #403 (April. 2021).

[5] Interim Guidance on Processing Form 1023-EZ, Control Number: TEGE-07-0521-0008, May 13, 2021.

See, e.g., letter of January 11, 2021[6] and congressional testimony.[7] We believe this approach remains sound but urge that in the interim, the IRS consider the solutions articulated above.

II. Definition of gross receipts for purposes of the Employee Retention Credit

Congress included charitable organizations in various COVID-19 relief laws, often by extending programs designed for for-profit entities to nonprofits. Treasury and the IRS have diligently developed interpretations to implement the will of Congress, specifically by defining nonprofit "gross receipts" in new ways. While largely helpful, confusion persists, and greater clarity is requested here.

The Coronavirus Aid, Relief, and Economic Security (CARES) Act included an employee retention tax credit designed to help businesses and nonprofits retain employees during the COVID-19 public health emergency. The credit was modified and expanded in December 2020, becoming the employee retention and rehiring tax credit, in the COVID-related Tax Relief Act of 2020, enacted as Subtitle B to Title II of Division N of the Consolidated Appropriations Act, 2021. For purposes of both the CARES Act and the Tax Relief Act credits, eligible employers are those that (1) are required to fully or partially suspend operations due to a COVID-19 related government order; or (2) have gross receipts either 50 percent or 20 percent less than gross receipts in the same quarter in the prior calendar year.

In Notice 2021-20, the IRS provides a definition of gross receipts for nonprofits. The answer to Question 25 states:

> "Gross receipts" for purposes of the employee retention credit, for a tax-exempt organization, has the same meaning as under section 6033 of the Code. Under the section 6033 regulations, "gross receipts" means the gross amount received by the organization from all sources without reduction for any costs or expenses including, for example, cost of goods or assets sold, cost of operations, or expenses of earning, raising, or collecting such amounts. Thus, gross receipts includes, but is not limited to, the gross amount received as contributions, gifts, grants, and similar amounts without reduction for the expenses of raising and collecting such amounts, the gross amount received as dues or assessments from members or affiliated organizations without reduction for expenses attributable to the receipt of such amounts, gross sales or receipts from business activities (including business activities unrelated to the purpose for which the organization qualifies for exemption), the gross amount received from the sale of assets without reduction for cost or other basis and expenses of sale, and the gross amount received as investment income, such as interest, dividends, rents, and royalties.

Under another provision of the CARES Act, a number of charitable nonprofits were able to receive Paycheck Protection Program ("PPP") loans based on the size of their payroll before the COVID-19 pandemic. In addition, many charitable nonprofits were able to achieve full or substantial "loan

[6] Comments on Exempt Organizations IRS Forms, National Council of Nonprofits, Jan. 11, 2021.

[7] Letter of the National Council of Nonprofits on Hate Group Hearing, submitted to House Ways and Means Subcommittee on Oversight, October 4, 2019; Comments on the Discussion Draft: The Taxpayer First Act, Submitted to House Ways and Means Subcommittee on Oversight, Apr. 6, 2018.

forgiveness" based on several factors. The IRS, in instructions to the current Form 990, has stated in Part VIII, line 1e that such loan forgiveness amounts should be reported as contributions from a government unit, rather than program service or miscellaneous revenue, in the tax year when the amounts are forgiven. In addition, consistent with such treatment, Form 990 Schedule A instructions provide that forgiven PPP loans should be treated as contributions for public support purposes.

The Consolidated Appropriations Act, 2021 also provided that businesses, including charitable nonprofits, would be eligible for a so-called "second draw" PPP loan if they could demonstrate a 25 percent reduction in gross receipts. The Small Business Administration (SBA), in consultation with the Department of the Treasury, provides guidance to assist businesses in calculating their revenue reduction and payroll costs (and the relevant documentation that is required to support each set of calculations) for purposes of determining their eligibility for and amount of a Second Draw PPP Loan. For all entity types (e.g., for-profit businesses and nonprofit organizations), the amount of any forgiven First Draw PPP loan is not included in the calculation of "gross receipts."[8]

Recommendations: Because there is confusion as to which components of Form 990, Part VIII Statement of Revenue should be included in the calculation of gross receipts, we urge the IRS to issue a detailed revenue procedure with numerous examples that demonstrate how a charitable nonprofit should make the calculations for purposes of the Employee Retention Credit gross receipts test. We believe such a revenue procedure would greatly assist charitable nonprofits as they attempt to qualify for the Employee Retention Credit that Congress intended.

We further recommend that the IRS specifically state that any PPP loan forgiveness proceeds be expressly excluded from the calculation of gross receipts. Congressional intent is clear. Such proceeds are not subject to federal income tax. Thus, they should be excluded from the gross receipt calculation.

III. Clarify Form 990 instructions to accurately report revenues from government grants and government contracts for services

The IRS Form 990 as currently written invites misleading and inaccurate reporting of nonprofit revenues received and earned from governments; it should be reformed.

Governments at all levels engage charitable nonprofits to provide vital services and compensate such nonprofits for those services pursuant to written agreements. The current Form 990 provides that government ***grants*** are reported at Part VIII, Line 1e – "Government grants (contributions)." Revenues earned pursuant to government ***contracts*** are reported under Line 2 – "(Program Service Revenue)," a category that can include Medicare and Medicaid reimbursements and payments for many other services. This reporting regime leads to greater confusion and creates a false narrative harmful to governments, nonprofits, and the public.[9]

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[8] See "Second Draw Paycheck Protection Program (PPP) Loans: How to Calculate Revenue Reduction and Maximum Loan Amounts Including What Documentation to Provide." issued by the SBA on January 19, 2021.

[9] As an aside, we applaud the IRS for definitively stating in the revised instructions to Form 990 that the amounts of PPP loans that are forgiven may be reported on line 1e as contributions from a governmental unit in the tax year that the amounts are forgiven.

The technical, legal distinctions between grants and contracts may make sense to accountants who deal with the differences on a daily basis. But the distinctions are neither self-evident nor logical to nonprofits or government employees operating in the real world. At the federal level, government ***grants*** are governed by the OMB Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards ("Uniform Guidance"); government ***contracts*** are controlled by the Federal Acquisition Regulations (FAR). However, at the state and local levels, governments refer to the written agreements with terms that government and nonprofit employees often use interchangeably – "grants" and "contracts" – even if the technical definitions in those jurisdictions mean something different. Indeed, in at least one state, the written agreement for nonprofit services performed on behalf of the government is called a "grants contracts." There is no clarity or consistency when similar terms mean different things, not only in different jurisdictions, but also among government officials and employees within the same jurisdiction.

Form 990, Part VIII, line-items 1e and 2 require nonprofits to divine and apply yet another set of categories for revenues earned through the performance of services pursuant to government written agreements, without relying on how the government that issued the written agreement labeled it. This quite clearly breeds confusion and generates unwelcome angst (e.g., "In reporting revenues, do I discard what the state or city called the agreement or reject the IRS instructions – and what are the consequences for either?"). Indeed, the Form 990 instructions themselves contain two references to the term "grants;" the second time it is used contains a potentially misleading reference to "grant" expenses related to "program services" (reported on Part VIII Line 2) rather than "contributions" (reported on Part VIII Line 1e).[10]

As currently structured, Form 990 invites inconsistent reporting which inhibits transparency among nonprofits. Confusion about where to report revenues earned via written agreements with governments can take inordinate time because of the inconsistent use of the terms "government grants" versus "government contracts." When organizations innocently report the data on the wrong line, it deprives the public of knowing the underlying facts. Indeed, nonprofits might be tempted to overstate amounts on Part VIII, Line 1e as it could demonstrate greater "overall support" which, in turn, could influence potential donors.

Further, Form 990, Part VIII line-items 1e and 2 create and perpetuate damaging narratives that governments charitably "give" money to nonprofits and foster a perception that certain nonprofits are dependent on government support. Such a narrative undermines support for nonprofits and prevents a full understanding of how governments and nonprofits operate together to achieve the public good. In reality, many of the government programs that affect the lives of residents are performed by charitable nonprofits pursuant to government grants. The declaration of the payments as "contributions" on line-item 1e trivializes such payments for the performance of essential services as mere gifts, as if they were voluntary and discretionary by government officials, or to use the outdated term, "alms." The IRS must alter Form 990, Part VIII to delete "(contributions)" to remove this inaccurate and harmful qualifier.

We agree with the views expressed by the Aspen Institute and others (Comments to the Internal Revenue Service Taxpayer First Act Office, July 3, 2020) that Form 990 Part VIII "now lacks sufficient

[10] See 2020 Instructions for Form 990 Return of Organization Exempt From Income Tax on p. 38 and 43. The language on page 43 can be especially misleading.

clarity with respect to the reporting of government revenue, confusing users of the form, and likely resulting in inaccurate reporting."[11]

Recommendation: As an interim step to resolving the challenges described above, we encourage adoption of Recommendations 2a and 2b of the Aspen Institute's comments. To provide clarity to Form 990 Part VII: (1) create a dedicated line for government reimbursements such as Medicare/Medicaid and contracts from government agencies that primarily benefit the agencies; and (2) clarify the distinction between government transfers (grants) and private charitable contributions and program service revenues and market sales.

We note here that the Financial Accounting Standards Board (FASB) released Accounting Standard Update 2018-8: *Clarifying the Scope and the Accounting Guidance for Contributions Received and Contributions Made*. It includes specific criteria differentiating whether a contract or agreement should be accounted for as a contribution or as an exchange transaction. According to the FASB, the determining factor is if the asset provider receives commensurate value in return for assets transferred to the nonprofit. If so, it is accounted for as an exchange transaction. If commensurate value is not received, it is deemed to be a contribution. Adoption of such an approach and reference to the text and examples in ASU 2018-8 would simplify the reporting of government grants and contracts in Form 990, Part VIII.

We further recommend that the IRS commit to a more thorough analysis of Form 990, Part VIII, with the goal of eliciting stakeholder input on how nonprofits can best report revenues earned pursuant to written agreements with governments at all levels. The networks of the Council of Nonprofits will certainly participate in such a review that promotes clarity, administrative ease, and public support.

The National Council of Nonprofits appreciates that the Treasury Department and the Internal Revenue Service continue to solicit public comments regarding their annual Priority Guidance Program. We will be happy to answer any questions or provide additional information regarding these recommendations or other issues impacting charitable nonprofits.

Sincerely,

David L. Thompson
Vice President of Public Policy

Steven M. Woolf
Tax Policy Advisor

[11] Comments to the Internal Revenue Service Taxpayer First Act Office submitted by Aspen Institute's Nonprofit Data Project on July 3, 2020, p.3.