

A Walk Through the IRS Form 1023: Applying for Section 501(c)(3) Recognition

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Forming a new nonprofit organization for charitable, religious, or educational purposes? How exciting! Doing so involves careful planning, leadership development, donor prospecting, and of course nonprofit paperwork. For Section 501(c)(3) tax-exempt status, that likely means completing the IRS Form 1023 application too. What is involved with the IRS Form 1023 application, and why is it so important not only for the coveted IRS approval but also for an organization's long-term success? The stakes are high, the details are of critical importance, and accompanying learning-curve opportunities may be quite helpful for nonprofit leadership.

The Stakes

The Internal Revenue Code classifies nonprofits that are organized and operated exclusively for charitable, educational, and/or religious purposes^[1] as not only exempt from federal income taxes but also eligible for tax-deductible contributions. Good news indeed! All nonprofits must obtain the IRS's official recognition of this coveted Section 501(c)(3) status, unless they are churches,^[2] church-affiliated nonprofits, or integrated auxiliaries.^[3]

Subject to these categorical exclusions, nonprofits must demonstrate that they meet the legal requirements under Section 501(c)(3) by submitting an application to the IRS. The standard version of the application is the Form 1023. An expedited version, called the Form 1023-EZ, may be filed instead, but only under limited circumstances, such as if the organization

reasonably expects to receive less than \$50,000 in revenues. As a result, most nonprofits are not eligible to file Form 1023-EZ, as it is basically a self-certification of federal tax-exempt status.[4] If an organization is eligible, filing Form 1023 may still not be preferable, particularly since filing Form 1023-EZ reportedly carries a higher risk of IRS audit.[5]

Nonprofits that successfully apply for Section 501(c)(3) approval receive an IRS determination letter. This IRS approval letter recognizes federal tax exemption effective as of incorporation, so long as the Form 1023 application was properly filed within 27 months of incorporation. With this caveat, all contributions made after incorporation should qualify for tax-deductible status, even if they were made before the Form 1023 application submission process.

How easy is it to pass muster with the IRS? By the statistical numbers, the answer seems comforting: the vast majority of IRS Form 1023 applications are approved. But there is room for significant caution. Last year, even though the IRS approved 90 percent of applications, 10 percent were delayed, rejected, withdrawn, or otherwise viewed as problematic.[6] Accordingly, it is best to make it easy for the IRS to say “yes” by submitting a well-done and complete Form 1023 application. Moreover, and as addressed further below, the IRS Form 1023 charts a course for the nonprofit’s future and is a permanent document subject to public disclosure. For all these reasons, an organization should strive for a well-prepared, accurate, and high quality Form 1023 application.

Key Tax Requirements

Before starting the Form 1023 application process, nonprofit leaders should familiarize themselves with applicable tax requirements. Of prime importance, all nonprofits applying for recognition of Section 501(c)(3) status must satisfy the Internal Revenue Code’s organizational and operational tests.[7] The organizational test focuses on the nonprofit’s charter or articles – that is, its documents. The charter document (typically, articles of incorporation) must include a corporate purpose statement that expressly lists one or more exempt purposes under Section 501(c)(3). The operational test requires that the nonprofit engages exclusively, meaning “primarily” in IRS tax parlance, in activities that accomplish one or more exempt purposes under Section 501(c)(3).

If just one substantial non-exempt purpose exists, then the applicant organization becomes ineligible for Section 501(c)(3) recognition. A commonly disqualifying non-exempt purpose is to make a profit or otherwise run a commercial business, as part of (or the entire) the organization’s intended activities. But nonprofit organizations need to primarily serve the public benefit, not private interests, in order to obtain IRS recognition under Section 501(c)(3).[8] A corresponding tax law principle is that the organization may not improperly use charitable resources or assets to benefit directors and officers, or any other corporate insider,

if it wants to obtain Section 501(c)(3) recognition. Further, a nonprofit cannot impermissibly benefit private interests to the detriment of the organization and the general public.[9] In short, the organization must be for the public good, not private interests.

The Complete Package

The complete IRS Form 1023 application should include the following components: (a) Form 1023 itself, including financial information and numerous questions calling for disclosure of qualifying Section 501(c)(3) information; (b) corporate documents sufficient to satisfy the operational test and otherwise demonstrate good governance; (c) supplemental responses that further address questions within the Form 1023 and otherwise explains how the organization satisfies the operational test; (d) accompanying schedules to the Form 1023, depending on the organization's purpose and activities; (e) supporting materials, such as a conflict of interest policy and website excerpts about the organization; and (f) Form 2848 power of attorney, if an attorney will submit the application on the client's behalf.

IRS Form 1023 – Key Questions, Right Answers

The IRS Form 1023 may be highly technical, but essentially it is aimed at eliciting both (a) key information about the applicant organization and (b) potential “red flag” areas warranting additional disclosures. The Form 1023 is divided into nine parts, as follows.

Part I seeks basic organizational information like name, EIN, and leadership.

Part II addresses corporate structure, including the essential requirement that the organization has bylaws.

Part III addresses essential Section 501(c)(3) qualifying requirements about the corporate purpose and distribution of charitable assets upon corporate dissolution. These initial requirements should not be problematic, but they can trip up an organization that has not done its initial legwork to develop legally-compliant organizational documentation.

Part IV is quite lengthy. It starts with a broad-brush question, calling for past, present, and future descriptive information about the organization's activities – all to be addressed in a high-quality narrative response, as addressed further below. Part IV then continues with a list of yes/no questions, seeking confirmation of legal compliance with Section 501(c)(3) (e.g., no political campaign intervention,[10] no impermissible private benefit), as well as questions that warrant further development through supplemental responses and possible additional materials. For example, if the applicant answers “yes” to the question about foreign grantmaking, then the applicant should correspondingly describe how it will distribute such grant funds solely in furtherance of Section 501(c)(3) purpose and consistent with a board-adopted anti-terrorism policy, which it should provide as an accompanying attachment.[11] Part IV continues with questions about particular types of nonprofit activities, such as

whether the organization will operate a school or provide low-income housing and how it will carry fundraising. Each of these questions may warrant more information from the applicant, depending on the answer.

Part V addresses compensation and related financial arrangements that could give rise to conflicts of interest.^[12] The IRS cares deeply about conflict of interest issues, such as may arise when a voting director is also paid by the organization. Such arrangement may be permissible so long as the director does not vote on his or her own compensation and the remaining directors make an independent determination that such compensation is in the organization's best interests. Such arrangement thus should be pursuant to a written conflict of interest policy, which is likewise provided to the IRS as part of the Form 1023 application.

Part VI is about money. More precisely, the applicant must provide financial projections (or history, if the organization has existed for some time) reflecting revenues and expenses that are consistent with how the organization has otherwise described itself.^[13] Additionally, such financial information should demonstrate well that the organization is not organized for a profit and that its revenues fit within the required public support elements for Section 501(c)(3) status. Financial information is thus of critical importance to a successful Form 1023 application.

Part VII addresses Section 501(c)(3) subclassification. In other words, an organization should qualify for both Section 501(c)(3) recognition as well as some further type of tax-exempt organization, such as a public charity, church, school, hospital, a type of "supporting organization," or a private foundation. Such subclassification carries extremely significant implications, particularly for future IRS Form 990 information returns and satisfaction of the applicable public support test. Careful evaluation and assistance of legal counsel thus may be essential to correctly navigating this portion of the Form 1023. Parts VIII and Part IX contain similar questions that likewise warrant careful attention for proper tax compliance.

The Supplemental Responses (Should) Tell the Story

The supplemental responses provide the applicant with an opportunity to explain its bona fide Section 501(c)(3) qualification through a supporting narrative. Basically, the organization should describe tax-exempt legitimacy in terms of its origins, founders, compelling needs to be addressed (as listed in Section 501(c)(3), such as charitable, educational, or religious), anticipated or existing activities, and future plans. At the most fundamental level, this information must answer the following questions:

1. What are the applicant's activities?
2. Who conducts in these activities?
3. Where do the activities take place?
4. What is the approximate percentage of time devoted to each activity?
5. What is the approximate percentage of resources spent on each activity?

6. How is each activity funded (e.g., donations, fees, grant or government funds, etc.)?
7. How does the activity further the applicant's exempt purposes?

The supplemental responses also contain answers to certain questions within the Form 1023, as identified above, such as fundraising, related directors, compensation arrangements, and conflict of interest compliance.

Nonprofit leaders should not treat this part of the application lightly. In practical terms, these descriptive responses function like a business plan which outlines the applicant's exempt activities in a way to match the Form 1023 financial projections. The IRS uses this plan to determine whether the applicant is compliant with Section 501(c)(3) parameters and thus deserves to be recognized as tax-exempt. In a larger sense, this information helps shape the organization's identity, public image, and future direction. In the end, it provides a great opportunity for a new nonprofit organization to introduce itself. For ultimate flexibility, the supplemental responses should be contained in a separate attachment to the Form 1023 application.

Additional Qualifying Materials

As mentioned above, the nonprofit applicant needs to satisfy both the organizational and operational tests. Consequently, the organization needs to submit articles of incorporation, any amendments thereto, and bylaws. Additionally, the applicant should submit its conflict of interest policy and any other relevant policies in light of its current or anticipated activities.

Provision of these materials means that the organization's board has already approved them. So keep the timing and order of steps in mind: develop a corporate purpose statement; identify the anticipated board members; form the organization through incorporation (with purpose statement and new board); apply for an EIN, develop the bylaws; identify appropriate policies; get the bylaws and policies approved by the board; and then file the Form 1023 application. Notably, the Form 1023 application and related materials may be developed in conjunction with these corporate development steps, as well as consecutively. But by the time the Form 1023 is submitted to the IRS, the initial corporate development steps should be complete.^[14]

Note too that a nonprofit applicant may need to fill out specific accompanying Form 1023 schedules, depending on if the organization:

1. Is a church, convention, or association of churches^[15] (Schedule A);
2. Operates a school, college, or university (Schedule B);
3. Seeks to principally provide hospital or medical care (Schedule C);
4. Is a Section 509(a)(3) supporting organization^[16] (Schedule D);
5. Submits the Form 1023 application after 27 months of incorporation (Schedule E);
6. Runs facilities for low-income housing (Schedule F);
7. Converted from a different kind of legal entity (Schedule G); or

8. Offers scholarships, fellowships, or educational grants (Schedule H).

It may be smart to also include the organization's website excerpts, program materials, and other sample documents – all to help credibly demonstrate its tax-exempt qualification.

Lasting Importance

Why else is the IRS Form 1023 application so important? Along with an organization's future IRS Form 990 annual information report filings, the Form 1023 is a permanent organizational document and is subject to public disclosure requirements. Consequently, due attention should be given not only to how the IRS will “vet” the organization, but also who else may read it in the future.

Additionally, the Form 1023 application's descriptive information prescribes the general range of appropriate activities for the future, since such information provides the basis for the IRS's approval. For example, if the applicant states that it will engage in educational activities to promote literacy, then it should not later engage in diametrically opposite activities for which it has not passed IRS muster (e.g., saving whales). Note, however, that it is legally possible and fairly common for organizations to incrementally change their activities and focus over time, and still retain their Section 501(c)(3) tax-exempt status – provided that such activities are properly reported through annual IRS Form 990 information returns. For an about-face on organizational activities, however, a new IRS application may be warranted.

Once the Form 1023 application is successfully approved with Section 501(c)(3) recognition, the resulting IRS determination letter should be a treasured document for nonprofits' continued vitality and success. The newly approved organization should closely review the IRS approval letter for effective date, correct tax-exempt subclassification, and applicable IRS Form 990 reporting obligations.

The IRS determination letter is also of importance for gaining support from foundations, government agencies, and other donors who may be conditioned on providing the IRS approval letter, as confirmation that contributions qualify for tax deductibility. Likewise, many state exemption applications (e.g., property, sales and use, and income and franchise taxes) may require the IRS determination letter as a condition of such state exemptions.

Furthermore, for states that impose charitable solicitation registration requirements on nonprofit fundraising, the IRS determination letter or the Form 1023 application is typically required.

In sum, getting through the IRS Form 1023 application process provides various opportunities and challenges, such as to develop a strong purpose statement, evaluate whether the anticipated activities fit within Section 501(c)(3) parameters, to make sure that operations will be legally compliant, and to address situations that could be potentially problematic later. In tax terminology, the Form 1023 thus provides a springboard for maximizing each applicant's organizational and operational success!

[1] For more information about corporate purpose statements, please see our W&O blog: [Nonprofit Corporate Purpose Statements: Legal Compliance under 501\(c\)\(3\) and Effective Communications](#).

[2] For the IRS definition of “church,” please see [Defining “Church” with an IRS Focus](#).

[3] For the IRS definition of “integrated auxiliaries,” please see [Integrated Auxiliaries: Tax Privileges and Qualification](#).

[4] For the eligibility requirements for filing Form 1023-EZ, please see [A New Year, a New 1023-EZ](#) and [Inside Peek at the IRS: Problems and Pitfalls of Form 1023-EZ Tax-Exemption Applications](#).

[5] [National Taxpayer Advocate Series, 1 Objectives Report to Congress, Fiscal Year 2017, 181 \(December 2017\), Area of Focus #14](#).

[6] The Data Book reports statistics for activities conducted from October 1, 2019 through September 30, 2020. [Internal Revenue Service, Publication 55-B, Data Book, 2020, 28 \(June 2021\)](#).

[7] The organizational and operational tests are addressed in the following W&O blog: [Do Something \(Right\)! How to Pass the Section 501\(c\)\(3\) Operational Test](#).

[8] For further guidance on this critical tax-exempt requirement, please see [Would You Like Some “Commerciality” With Your Coffee? Structuring Tax-Exempt Business Activities Under Section 501\(c\)\(3\)](#).

[9] For a detailed discussion on inurement and impermissible private benefit, please see [Promoting the Nonprofit Mission, Not Doling Out Business Favors](#).

[10] Nonprofit organizations organized and operated under Section 501(c)(3) are prohibited from political electioneering, but they may engage in an “insubstantial” amount of lobbying and unlimited “educational issue advocacy.” For more information, please see [Call Your Legislator Today! \(or Not?\): Lobbying Basics for Nonprofits](#) and [Christians Engaged: Getting Religion, Politics, and Public Charity Status Right](#).

[11] For more information about foreign grant-making, please see our W&O blog articles: [Christians Engaged: Getting Religion, Politics, and Public Charity Status Right](#), [International Grant-Making: Staying Legal with Grantees and Sub-Grantees](#), and [OFAC Releases New Guidance on International Sanctions Compliance](#).

[12] For more information about conflicts of interest and the corresponding fiduciary duty of loyalty, please see our W&O blog article: [Wearing the Right “Hat”: the Duty of Loyalty](#).

[13] The number of required years depends on the nonprofit's incorporation date. In particular, a new organization needs to provide good faith estimates for the current fiscal year, and two subsequent tax years. Alternatively, if a nonprofit has been in operation for more than one year but less than five, it needs to provide information for four years, (current fiscal year, and three previous tax years).

[14] For more information about the "startup" process, please see [Starting a Nonprofit 501\(c\)\(3\)](#).

[15] As stated above, churches and church-affiliated nonprofits are exempt from applying for IRS recognition of federal tax-exempt status. However, there are situations where a church may need an IRS determination letter. For example, a church that intends to employ a non-U.S. citizen pastor needs an IRS determination letter to satisfy federal immigration laws. Churches do not have the option of filing IRS Form 1023-EZ. All churches seeking an IRS determination letter must submit the IRS Form 1023 application.

[16] For a definition of "supporting organizations," please see [Supporting Organizations: Options for Meeting Section 501\(c\)\(3\)'s Public Support Test](#).



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