

# Ready to Launch? How the 1023-EZ Has Changed Your Nonprofit Start-Up Options

by Tivoni Devor and Laura N. Solomon, Esq.

One big reason why small organizations choose fiscal sponsorship over forming a 501(c)(3) is *speed*: the Form 1023 takes three to six months to process, while fiscal sponsorship is very quick. Now, however, we have the 1023-EZ, whose process takes only weeks. But there are many reasons for opting for a fiscal sponsor beyond start-up speed—and, as it turns out, there are some disadvantages associated with the 1023-EZ. The truth is, the new form is not as, well, *easy* as it may first seem.

**Editors' note:** *The 1023-EZ provides an opportunity to launch a 501(c)(3) faster—changing some of the assumptions of the requirements of nonprofithood. And when you marry that lower barrier to tax exemption to the 990-N (e-Postcard), the standards and reporting requirements become minimal. This changes the way we look at the choice of whether or not to become a nonprofit, which changes the need base for fiscal sponsors, and so on. It goes back to the old systems thinking adage: “You can’t do just one thing.”*

**A**RE YOU TRYING TO DECIDE BETWEEN forming your own independent 501(c)(3) charity and using a fiscal sponsorship?

Your decision would have been straightforward before July 1, 2014—the date the IRS issued the Form 1023-EZ Streamlined Application for Recognition of Exemption. Until then, if you had a charitable mission *and* enough money for the legal, accounting, and filing fees, you would have incorporated a nonprofit corporation and filed the IRS Form 1023 to get 501(c)(3) status. If instead you had only a short-term project, or if you lacked funding, you would have used a fiscal sponsor. That sponsor would have received and receipted charitable contributions on your behalf, and made distributions for your expenses—typically

for a fee equal to a percentage of the funds you raised. The fee a fiscal sponsor charges covers your portion of the overhead costs associated with running a nonprofit (administrative staff, insurance, Form 990, audit, etc.).

But the IRS Form 1023-EZ has changed the equation. Now, the cost-benefit analysis is different, because the IRS made it cheaper and easier for many organizations (most organizations with gross receipts of \$50,000 or less and assets of \$250,000 or less) to apply for tax-exempt status. Instead of an IRS filing fee of \$850 for the 1023 for organizations with \$50,000 or more in revenue, the filing fee for the 1023-EZ is \$275. And, instead of the significant legal fees to complete the 1023, the 1023-EZ requires much less attorney time. And then there is the

near-instant gratification: Form 1023 processing—which has gotten faster—typically takes three to six months; the IRS processes Form 1023-EZ in a matter of weeks.

The IRS has, in essence, lowered the barrier of entry for new charities. This can be a good thing if the charitable mission is worthwhile and the founder has the knowledge, commitment, and resources to pursue that mission. But this lowering of the barrier has also been controversial. The longer and more detailed Form 1023 requires significant disclosures, including three years of projected budgets, a detailed narrative description of activities, articles of incorporation, and by-laws. These aid the IRS agent's review in determining whether the organization is legitimately formed and will

be operated for charitable purposes, allowing the IRS to weed out unqualified would-be charities. Conversely, the IRS Form 1023-EZ is just three pages long, with boxes to check—and applicants self-certify as to the charitable nature of the organization and its planned activities.

According to a recent IRS Taxpayer Advocate Service Annual Report to Congress, the brevity of the 1023-EZ has caused the IRS to erroneously grant 501(c)(3) status to unqualified organizations.<sup>1</sup> The net effect is a proliferation of new charities that, but for the 1023-EZ, would have either not been approved by the IRS or launched under fiscal sponsorship. Long term, this may lead to inefficiencies, as an increasing number of organizations create duplicative services and infrastructure while competing for the same grants and contributions. A single fiscal sponsor can efficiently

sponsor hundreds or even thousands of activities under the umbrella of one legal entity, reducing administrative and programmatic expenses. Ironically, many grantmakers have recently begun funding mergers and collaborations to counteract existing duplications. As funders push for consolidation, the 1023-EZ makes proliferation all the more easy.

*The Nonprofit Quarterly* asked Laura N. Solomon, Esq., founder of Laura Solomon & Associates, and Tivoni Devor, manager of partnerships and outreach at the Urban Affairs Coalition, to debate this new wrinkle in the decision-making process for start-up nonprofits.

### *When and why do you recommend fiscal sponsorship or 501(c)(3)?*

**Laura Solomon:** I recommend fiscal sponsorship when a client has a short-term or single project, like a client of mine who rowed across the Atlantic Ocean to raise money for ALS. I also recommend fiscal sponsorship or a donor-advised fund when an individual or group doesn't have the money or appetite for the ongoing responsibilities of running a nonprofit. A good fiscal sponsor can provide the platform to further great charitable missions and programs nationally and even internationally. Conversely, if a founder has a serious commitment to the mission and the responsibilities of starting and running a nonprofit—together with the financial and other resources—an independent 501(c)(3) may be the right choice.

**Tivoni Devor:** Naturally, I am a big proponent of fiscal sponsorship for short- and long-term projects, both big and small. But now that we have the 1023-EZ, I usually recommend that especially small nonprofit start-ups—those with budgets under \$50,000—use the 1023-EZ. Smaller organizations typically don't need all the bells and whistles of a full-service fiscal

sponsor. They don't have staff, so they don't need HR support, nor do they need to provide any payroll or benefits. Their finances are simple and can usually be done in Excel or QuickBooks. A sub-\$50,000 nonprofit can also choose to file the Form 990-N during tax season, a form that is also called the e-Postcard 990 because it is so easy to complete—and organizations that file a 990-N fall under most audit-compliance thresholds. I tell small nonprofits that are not projecting to cross the \$50,000 level to go with the 1023-EZ first, and then, when they grow and scale, to look to fiscal sponsorship to help them manage that growth and the challenges associated with that growth.

### *What are the pros and cons of each?*

**LS:** The advantages of having your own charity are clear. You have control over your activities, finances, and mission. With that control comes the “cons,” though—which include the costs and burdens of start-up and compliance together with the significant job of running a nonprofit, including formation of a working, engaged board of directors. Fiscal sponsorship provides freedom from those costs and burdens but also comes with the “cons” of the fiscal sponsorship fee and a lack of control. Some sponsored projects find that, as they grow, larger or more established donors want to see that the project is its own independent 501(c)(3)—perhaps as a sign of legitimacy, permanence, or commitment. Other donors simply won't make a gift through a fiscal sponsor because they know that a portion of their donation is going toward sponsorship fees.

**TD:** I'll push back a little on the “cons” of fiscal sponsorship when you talk about the fees and control. As you are considering choosing between fiscal sponsorship and your own 501(c)(3),




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you have to weigh the costs of the fees you are paying against the expenses of doing it yourself. Often, we find savings for 501(c)(3)s when they join us, especially in audit, insurance, and employee benefit costs. Your fiscal sponsor should have an economy of scale that reduces these costs for you. Now, each organization that provides fiscal sponsorship is different and offers different levels of oversight that may feel controlling. Often, independent organizations are able sometimes to play a little fast and loose in terms of compliance, but for a large fiscal sponsor with many client partners, one bad apple can spoil the bunch. One bad act of a single client's may trigger a funder to avoid funding any client using the same fiscal sponsor, and I will agree that fiscal sponsors can be bureaucratic and risk averse. Sometimes we turn down an applicant if the organization's program combines power

tools and youth, or has a business model that may seem to have some inherent conflicts of interest between the funders and the program. In the long term, risk management is what keeps programs operational and sustainable, especially in environments where nonprofits can be attacked for all sorts of administrative and financial reasons.

**LS:** I also strongly recommend that any fiscal sponsorship relationship be documented with a fiscal sponsorship agreement that sets out all of the responsibilities of each party, including the fees, obligations of the sponsor, accounting for funds and reports, ownership of intellectual property, and timing and requirements for distributions of funds upon termination. I've seen problems with "divorcing" projects, in which the parties end up arguing over the intellectual property created by the project, or get

frustrated when the sponsor won't grant the balance of funds to a new sponsor or 501(c)(3) that the project forms.

**TD:** I completely agree. When one nonprofit fiscally sponsors another and it is not its main mission and there is no agreement, I call that *casual fiscal sponsorship*, and it can lead to all sorts of trouble. I define *formal fiscal sponsorship* as a partnership with a nonprofit whose mission is to provide fiscal sponsorship as a service and that has a clear agreement for you to sign.

*When does fiscal sponsorship make more sense than getting your 501(c)(3), and vice versa?*

**LS:** There's no one-size-fits-all approach here. My job as counsel is to review each option and its pros and cons in depth, and to guide the client to the option that's right for that particular client. It will

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depend on the personalities involved, depth of commitment, time horizon for the activity, and resources.

**TD:** Each nonprofit is different, just like each fiscal sponsor is different. It has to be a beneficial partnership. The fiscal sponsor must be able to provide a platform for the client partner to grow and flourish, and the client partner must be mission-aligned with, and not a financial burden on, the fiscal sponsor. In general for a start-up, if you want to launch your nonprofit quickly and with access to the experience and support of an invested partner, go with a fiscal sponsor. If you want to work inside a community, being a part of a fiscal sponsor's family of projects gives you access to deep nonprofit knowledge, networks, and flexibility that you may not have on your own. But if you want to launch a cheap and nimble organization so that you can take risks and experiment and have no bureaucracy, go with a 501(c)(3). Keep in mind, however, that in doing so you expose yourself to compliance issues in the long run due to the new streamlined application.

**When would it make sense to do fiscal sponsorship followed by 501(c)(3) status, or both, concurrently?**

**LS:** If a client is planning to apply for 501(c)(3) status but believes that it will take some time to gather the resources, fiscal sponsorship may be a great short-term option so that fundraising can begin. In fact, some clients put a fiscal sponsorship arrangement in place while they start up, so that they can fundraise as soon as they incorporate and while the 1023 is pending with the IRS. Note, though, that this makes sense for organizations filing the 1023 but not the 1023-EZ. That's because the 1023 takes three to six months, typically, but our firm has gotten 501(c)(3) status for clients using the 1023-EZ in as little as ten

days. Remember, though, to focus on the fiscal sponsorship agreement termination provisions and to make sure that any funds remaining with the sponsor can be paid out to the new 501(c)(3) once it gets its exemption.

**TD:** Often, this is funder driven—as in a funder wants to give a client money but the client can't accept it without access to a 501(c)(3). We see this often, and we find a way to quickly ramp up so that the client can take advantage of the funder's interest and time line. My organization, the Urban Affairs Coalition, has been doing fiscal sponsorship for over forty-seven years, and we've had fiscally sponsored programs leave to be 501(c)(3)s and then come back to us a few years later. We've also seen groups with fiscal sponsorship as well as their own 501(c)(3) to manage property or, again, to satisfy a funder's requirement.

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In the end, deciding between getting a fiscal sponsor or using the 1023-EZ to register as a 501(c)(3) may be based on simple geography—for instance, is there a fiscal sponsor in your area that you trust? Also, it may be good to have both: you can have your programming occur under fiscal sponsorship and leverage the advantages of fiscal sponsorship, but keep your real estate or intellectual property separate under an independent 501(c)(3), and have legal agreements signed between the two.

**NOTE**

1. Taxpayer Advocate Service, *FORM 1023-EZ: The IRS's Reliance on Form 1023-EZ Causes It to Erroneously Grant Internal Revenue Code § 501(c)(3) Status to Unqualified Organizations*, MSP #19, "Most Serious Problems," 2016 Annual Report to Congress, vol. 1 (Washington, DC: Internal Revenue Service, 2016): 253–65.

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**If You Are Thinking about How Best to Launch a New Charitable Activity . . .**

1. First, articulate your mission and draft a time line for your activities and a proposed budget of your revenues and expenses for the first three years.
2. Then, check to see if you're eligible to use the new IRS Form 1023-EZ (starting on page 11 of the instructions, [www.irs.gov/pub/irs-pdf/i1023ez.pdf](http://www.irs.gov/pub/irs-pdf/i1023ez.pdf)).
3. Learn more about fiscal sponsorship.
4. Consult with a lawyer who can help you to evaluate the best option to further your mission.

**To Learn More . . .**

1. IRS website ([www.irs.gov](http://www.irs.gov))
2. IRS Form 1023 ([www.irs.gov/pub/irs-pdf/f1023.pdf](http://www.irs.gov/pub/irs-pdf/f1023.pdf))
3. IRS Form 1023-EZ ([www.irs.gov/pub/irs-pdf/f1023ez.pdf](http://www.irs.gov/pub/irs-pdf/f1023ez.pdf))
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