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# **Applications for 501(c)(3) Tax- Exempt Status Declining**

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## **Recession or Rule Change?**

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Amy S. Blackwood and  
Katie L. Roeger

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January 2013

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 URBAN INSTITUTE

## Applications for 501(c)(3) Tax-Exempt Status Declining: Recession or Rule Change?

by Amy S. Blackwood and Katie L. Roeger  
The Urban Institute  
January 2013

The Great Recession undoubtedly affected millions of nonprofits. Decreases in funding and simultaneous increases in clients seeking services left nonprofits to do more with less. While some weathered the storm, others chose to merge with similar organizations, cut services, or close their doors. What about new nonprofits, though? Did we see new nonprofits form during the recession? On one hand, there are more people seeking services from public charities, which might lead to more nonprofits being created; on the other hand, there are many fewer resources, which might inhibit the creation of new organizations. Using the Internal Revenue Service (IRS) *Data Book*, we investigate whether the recession affected the number of applications for new nonprofits.<sup>1</sup>

According to the *Data Book* released in April 2010, the IRS has ruled on nearly 30 percent fewer applications for 501(c)(3) tax-exempt status since the start of the recession in 2007.<sup>2</sup> While the recession no doubt dissuaded at least some individuals from starting public charities, it is not the sole cause of the sharp decline.

On September 9, 2008, the IRS eliminated the advanced ruling process for 501(c)(3) organizations. Before this change, organizations initially filing Form 1023 (Application for Recognition of Exemption under Section 501(c)(3) of the Internal Revenue Code) could qualify for an advanced ruling permitting them to be treated as publicly supported organizations for the first five years of their existence. This trial period gave an organization time to build public support and prove it met one of the public support tests.<sup>3</sup> At the end of the five-year period the organization would file Form 8734 (Support Schedule for Advance Ruling Period), and the IRS would then determine whether or not it met the public support standard during those five years. If the organization did not meet the public support standard, it would be classified as a private foundation.

The new regulations simplified the process for organizations by eliminating the need for most organizations to file Form 8734. With the elimination of the advanced ruling process, a qualified 501(c)(3) organization is classified as a public charity if it demonstrates on its application that it can reasonably expect meet the public support standard. The organization will maintain its tax-exempt status during the first five years whether or not it is actually publicly supported. After five years, the organization must demonstrate on its Form 990 that it meets the public support standard.

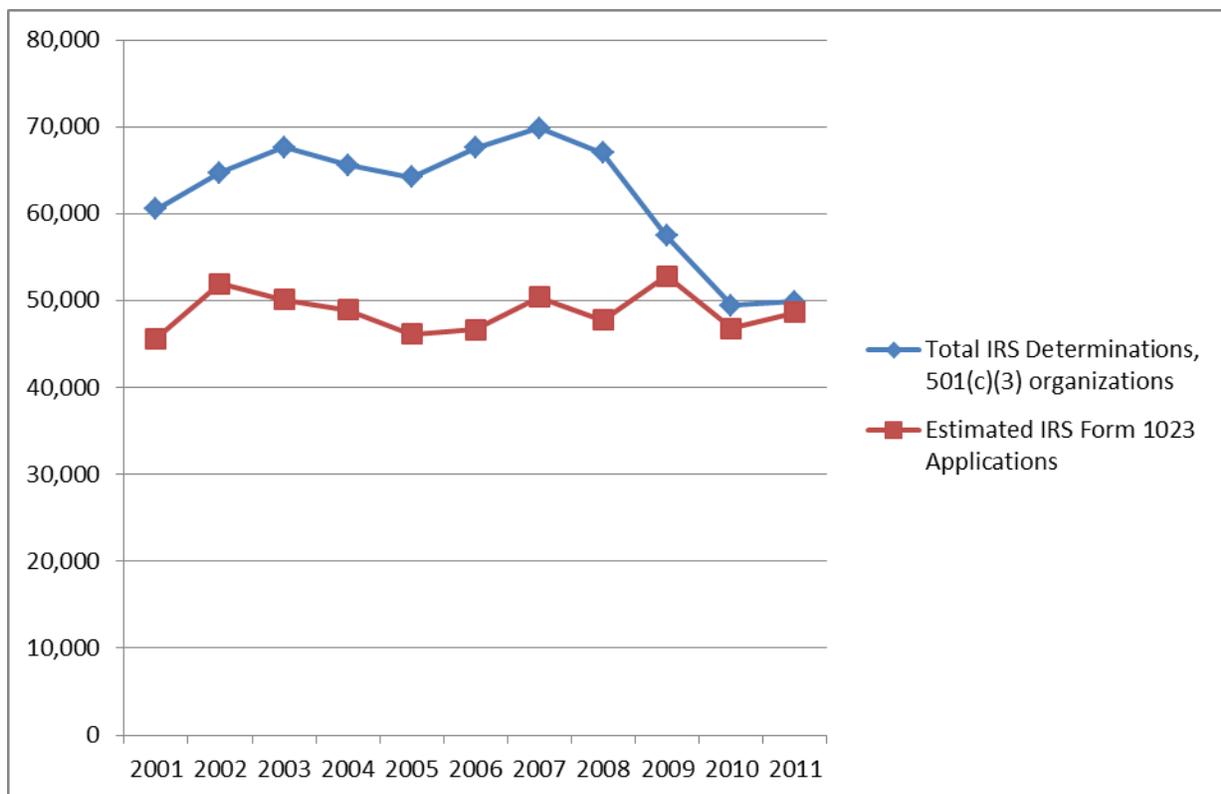
If one looks solely at total determinations issued by the IRS as a proxy for the number of new applications for 501(c)(3) status each year, the numbers would be inflated. Under the old system, the organization was reported in the IRS *Data Book* numbers when it initially filed the Form 1023 requesting exemption as a 501(c)(3) public charity, and again when the organization filed Form 8734 for its final determination to see if it met the public support standard (these determinations are referred to as

“foundation follow-up cases”). As a result, the same organization would be counted twice. Under the new system, organizations filing for public charity status file only the Form 1023 and are no longer required to file Form 8734; so, the numbers from 2008 onward should more accurately reflect the number of new applications for 501(c)(3) tax-exempt status.<sup>4</sup>

According to the IRS Statistics of Income Division, from 2001 to 2008 the IRS averaged over 19,000 foundation follow-up cases, or rulings on Form 8734, per year.<sup>5</sup> If we exclude the number of these cases each year, we see no dramatic change in the number of applications for tax-exempt status (Form 1023) during the recession. On average, the IRS made determinations on approximately 49,000 applications for 501(c)(3) tax-exempt status per year since 2001. The applications ruled on during the recession did not deviate much from the average.

Figure 1 displays the total number of IRS determinations as reported in the IRS *Data Book* and the estimated number of Form 1023s received since 2001 (the estimates exclude Form 8734 applications included in the *Data Book* figures). If we look at the total number of determinations issued by the IRS (top line), we see a sharp decline from 2008 to 2009. While it is intuitive to attribute this to the recession, if we look at our estimated number of Form 1023 applications ruled on by the IRS (bottom line), we see that the steep decline was due almost exclusively to the elimination of the advanced ruling process.

**Figure 1. IRS Determinations and Estimated IRS Form 1023 Applications, 2001–11**



Source: IRS *Data Book* 2010; IRS Statistics of Income Division.

Even with the decrease in available resources for public charities, the recession does not appear to have slowed the creation of new nonprofits. While we did see a 5 percent drop in the number of new applications in 2008, the 2008 figures were still higher than the number of new applications in 2006. In addition, 2009 actually had the highest number of applications for new charities of the previous 10 years. The 2009 spike could indicate that the needs of those affected by the recession spurred people to organize and create organizations to meet those needs. Another likely explanation is that organizations already planning to apply simply waited until the elimination of the advanced ruling process to officially apply for tax-exempt status. The recession seems to have had little effect on the creation of public charities.

## SOURCES

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<sup>1</sup> Each year, the IRS publishes the *Data Book*, a catalog of reports and tables on collecting revenue, issuing refunds, enforcing the tax code. One report, specific to the nonprofit sector, focuses on applications for tax-exempt status. Applications include first-time application (new nonprofits) as well as applications for changes in status, such as changing from a private foundation to a public charity.

<sup>2</sup> See Table 24 (Closures of Applications for Tax-Exempt Status, by Organization Type and Internal Revenue Code Section) at <http://www.irs.gov/taxstats/article/0,,id=207380,00.html> for more information. For the purposes of this brief, we look only at 501(c)(3) determinations and exclude “other” closures, which include applications withdrawn by the organization; applications that did not provide the required information; incomplete applications; IRS refusals to rule on applications; applications forwarded to an office other than the Washington, DC, office; IRS correction disposals; and others.

<sup>3</sup> According to the IRS, an organization is considered a publicly supported charity if it meets one of two tests:

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1. The organization receives a substantial part of its support in the form of contributions from publicly supported organizations, governmental units, and/or the general public.
  2. The organization receives no more than one-third of its support from gross investment income and more than one-third of its support from contributions, membership fees, and gross receipts from activities related to its exempt functions. (<http://www.irs.gov/charities/charitable/article/0,,id=185584,00.html>)

<sup>4</sup> Under the new system, organizations that received advanced rulings that expired on or after June 9, 2008, were automatically classified as publicly supported charities and no longer needed to file Form 8734. (<http://www.irs.gov/charities/charitable/article/0,,id=184670,00.html>)

<sup>5</sup> The number of foundation follow-up cases is not available before 2001.