

# NORTH COUNTY *Lawyer*

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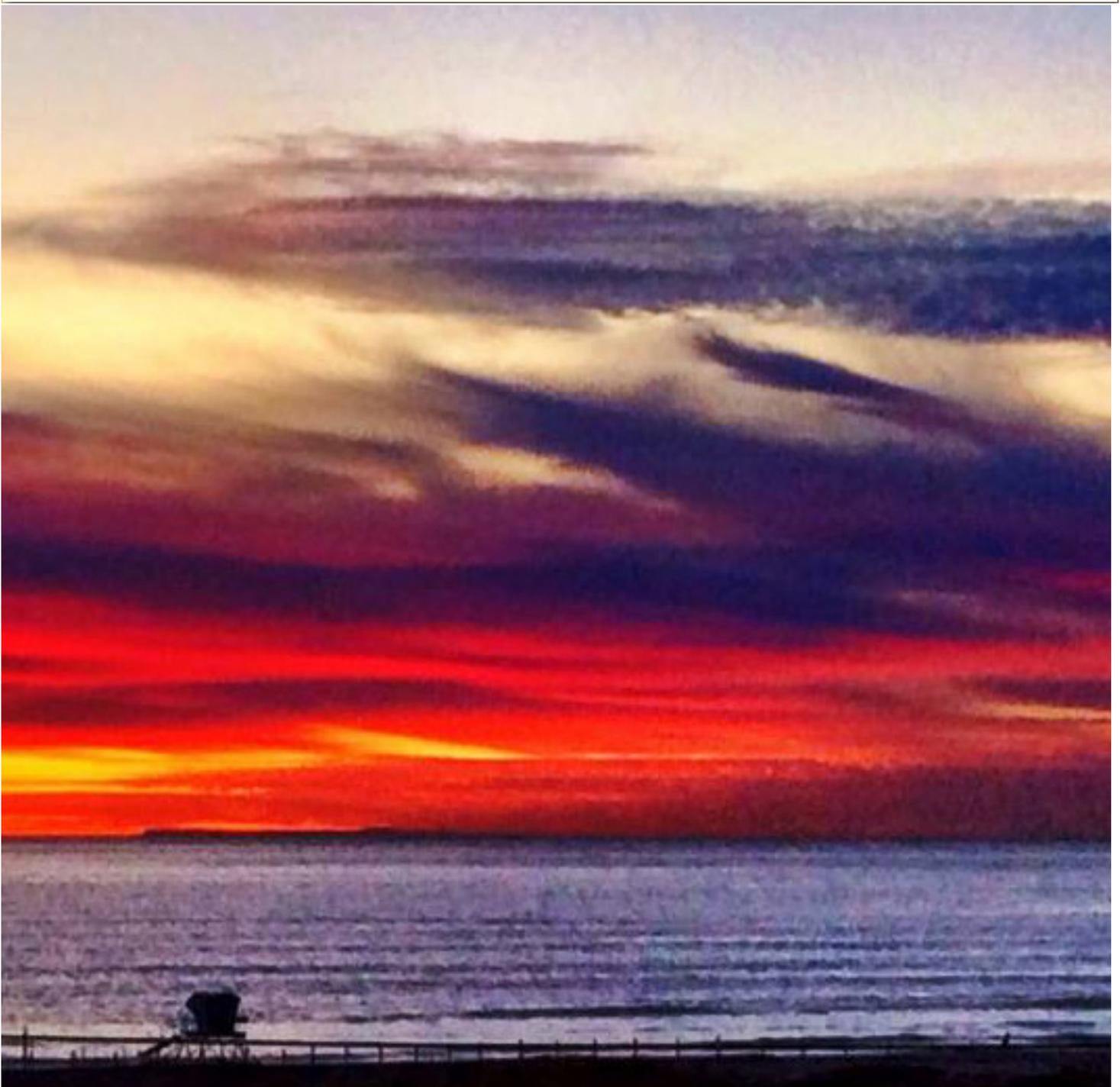


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# LETTER FROM THE EDITORS

By Vik Chaudhry, Wayne Templin and Audrey Powers Thornton

**W**elcome to the first edition of the new year 2015 of the North County Lawyer! We will continue to work hard to keep you up to date with news about the legal community in North County and the changes in the state of the law that will affect you.

This issue includes: "The State of the Judiciary" by **Judge William S. Dato**, who will serve as Supervising Judge in North County; our regular contributor, **Eric P. Ganci** has written another interesting #crimpro article, and an important tax update by **Michael Folz Wexler** "New IRS Form 1023-EZ, A Rubber Stamp?"

Looking forward to the future of our North County legal community and to a great 2015, here are two quotes to remember at the start of this new year:



*"The future belongs to those who believe in the beauty of their dreams." - Eleanor Roosevelt*

and:

*"To expect the unexpected shows a thoroughly modern intellect." - Oscar Wilde*

Happy New Year!

*by Audrey Powers Thornton*



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# ***NEW IRS FORM 1023-EZ - A RUBBER STAMP?***

*By Michael Folz Wexler, Esq*

**O**n July 1, 2014, the Internal Revenue Service gave a break to many new charities, when new IRS Form 1023-EZ was finalized. This short online form offers an easier and cheaper way for charitable start-ups to apply for recognition of tax-exempt status under Internal Revenue Code (IRC) section 501(c)(3). For a small "vanilla" charity, Form 1023-EZ unquestionably saves effort, time, and fees, compared to the regular Form 1023.

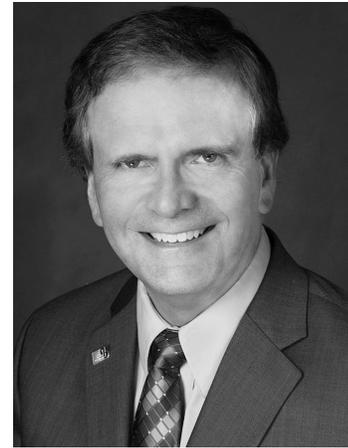
Although burdensome, the regular Form 1023 does provide "basic training," by alerting charities to various issues and pitfalls, and inducing them to develop operating plans and policies. The new Form 1023-EZ requires scant information about a charity's intended activities, thereby curtailing disclosure to the IRS, to states' charity regulators, and the interested public (Form 1023 being publicly disclosed after a charity is approved). In issuing Form 1023-EZ, the IRS flouted the warnings of its own 2012 Advisory Committee. For those stakeholders concerned with educating charity officers and with preventing fraud, July 1 was a disconcerting day.

For attorneys and other professionals who promote philanthropy by assisting charities, Form 1023-EZ provides opportunities for outreach and education, while underscoring the obligation to advise prospective founders of charities about their eventual responsibilities. Form 1023-EZ does nothing to simplify Federal and California laws regulating charities.

## **1. LIFE IN THE FAST LANE**

In the first seven weeks after July 1, about 7,000 charities filed IRS Form 1023-EZ -- nearly half of the total applications. For most 1023-EZ filers, tax-exempt status was approved in less than a month. By contrast, the median processing time for the regular Form 1023 was still over six months.

Form 1023-EZ is filed online at [www.pay.gov](http://www.pay.gov), with barely 3 pages of basic information and Yes/No questions. No articles, bylaws, or other legal documents are sent to the IRS. Instead of a narrative description of the charity's purpose and activities, Form 1023-EZ requires only a three-character code from the Urban Institute's National Taxonomy of Exempt Entities. (For example, Re-



medial Reading and Encouragement is NTEE code B92.) No more than 5 directors and officers can be listed on Form 1023-EZ.

Regular Form 1023 comprises over 60 questions on 12 pages, plus narrative descriptions, projections of income, expenses, and compensation, extra schedules for particular types of charities, and required attachments of legal documents. All directors and officers must be identified, as well as related organizations.

For eligible charities, using Form 1023-EZ saves substantial time and effort compared to regular Form 1023. Better yet, the filing fee for Form 1023-EZ is only \$400, compared to \$850 for most charities filing regular Form 1023.

Form 1023-EZ can help not only new charities, but also many existing charities whose tax exemption was revoked. In recent years, hundreds of thousands of charities and other nonprofits have had their tax-exempt status revoked automatically after 3 consecutive years of failing to file any annual IRS tax returns (IRS Forms 990, 990-EZ, or 990-N). Previously, those revoked charities all had to file regular Form 1023 with the past-due tax returns to request reinstatement of their tax-exempt status. Since July 1, though, charities that were revoked recently can use Form 1023-EZ if they are small enough to be eligible. Many revoked charities may benefit from this easier reinstatement procedure. Just in Carlsbad, Vista, and Escondido, about 25 charities have been automatically revoked so far in 2014. Search at <http://apps.irs.gov/app/eos/>.

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## **2. ELIGIBILITY FOR FORM 1023-EZ**

Both Form 1023 and Form 1023-EZ are only intended for charities seeking exemption under IRC Section 501(c)(3). Other types of nonprofit organizations would still be filing regular IRS Form 1024, which is not much shorter than regular Form 1023. Examples of these other nonprofit organizations are IRC 501(c)(4) social welfare organizations, IRC 501(c)(5) labor unions, IRC 501(c)(6) chambers of commerce, and IRC 501(c)(7) social clubs. For them, there is no corresponding Form 1024-EZ (yet).

Although Form 1023-EZ is short, its Eligibility Worksheet (in the Instructions) is 7 pages long, with 26 questions that must all be answered "No" to be eligible. These questions fall into 4 groups: types of charitable activity; past history; legal entity status; and financial thresholds. See <http://www.irs.gov/uac/About-Form-1023EZ>

### **A. TYPES OF CHARITABLE ACTIVITY**

Form 1023-EZ is unavailable for certain charitable activities that attract extra scrutiny from the IRS. For example, churches, schools, hospitals, and credit counseling services are ineligible. Most charities will know right away if they fall into any of those excluded activities.

### **B. PAST HISTORY**

Form 1023-EZ is also unavailable for charities whose history raises particular concerns. If a charity is a successor to a for-profit business, it has to file regular Form 1023 with Schedule G, to guard against impermissible benefits to the former owners. If a charity is a successor to, or controlled by, an entity suspended under IRC section 501(p) (suspension of tax-exempt status of terrorist organizations), it obviously would not be suitable for streamlined approval using Form 1023-EZ.

### **C. TYPE OF LEGAL ENTITY**

Limited Liability Companies (LLCs) are ineligible for Form 1023-EZ. Charities formed under the laws of a foreign country, along with U.S. charities having a foreign mailing address, are also ineligible.

### **D. FINANCIAL CEILINGS (CRYSTAL BALL NOT INCLUDED)**

Because Form 1023-EZ is intended for small charities, any charity with current assets exceeding \$250,000 is ineligible. Likewise, if a charity has had annual gross receipts exceeding \$50,000 in any of the prior three years, it is also ineligible. Both of those ceilings are reasonable, based on actual figures.

The most controversial item in Form 1023-EZ is Question 1 on the Eligibility Worksheet. A charity is ineligible if it projects that it will have gross receipts in excess of \$50,000 in the current year or in either of the following 2 years. A ceiling based on projections is of dubious value. For a new Public Charity that is just starting out to solicit donations, its projections of future donations are guesstimates at best. Even if a small charity genuinely intends to limit its fundraising focus to small donations from individuals, its website might attract a large donation that would push total gross receipts above the ceiling, in any of its first 3 years. As discussed below, the 2012 IRS Advisory Committee recognized that some charities might be inclined to low-ball their projections just to be eligible for Form 1023-EZ. But given the unpredictability of future donations from the public, it would be difficult to prove that a particular projection was deliberately low-balled.

Because a Private Foundation is controlled by its major donor, its projected revenues depend upon that donor's intentions. A wealthy donor could simply decide to limit his or her contributions to under \$50,000 for the first three years, then super-size the Private Foundation in Year 4 with a million-dollar contribution. In the long run, the \$50,000 ceiling is dubious for Private Foundations and Public Charities alike.

At this point, it is uncertain what the IRS will do if a charity files Form 1023-EZ based on modest qualifying projections, but actually attracts more than \$50,000 of gross receipts. The charity should disclose the unexpectedly high gross receipts on Form 990, Schedule O. It is doubtful that the charity would be required to reject and refund any contribution that breaches the ceiling.

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### **3. FORM 1023-EZ - JUST A FEW MORE QUESTIONS**

At the top of Form 1023-EZ is a checkbox to attest that the charity has completed the Eligibility Worksheet, is eligible to apply using Form 1023-EZ, and "ha[s] read and understand[s] the requirements to be exempt under section 501(c)(3)." The Instructions do refer to 10 IRS Publications concerning such requirements for exemption.

Most of Form 1023-EZ is straightforward. Part III requires the charity to describe its activities with the three-character code from the National Taxonomy of Exempt Entities ("NTEE"). Three pages of fine print in the Instructions list about 500 NTEE codes, though elsewhere the Instructions duly note that some of those codes are not applicable to 501(c)(3) charities. That list is searchable at <http://nccs.urban.org/classification/index.cfm>

Six bullet points describe prohibited or restricted activities, such as political campaigning and providing undue economic benefit to private persons. The charity checks another box to attest that it will not violate those prohibitions. To this limited extent, Form 1023-EZ does actually educate founders about Federal regulations on charities.

Part III concludes with 8 questions that can be answered yes or no without disqualifying the charity. Each of these activities is permissible subject to applicable limits and procedures, so these can be called "yellow-flag" questions. Will the charity:

- attempt to influence legislation?
- pay compensation to its officers or directors?
- provide grants or scholarships to individuals?
- conduct foreign activities or grantmaking?
- engage in financial transactions with officers or directors?
- have unrelated business gross income over \$1,000?
- operate bingo or gaming?
- provide disaster relief?

It is possible that if a charity answers Yes to many or most of these questions, its exemption application may be scrutinized more closely. However, in one case a charity was quickly approved even though it answered Yes to 3 questions: compensation, grants to individuals, and financial transactions.

In Part IV, the new charity indicates whether it will be a Public Charity (defined in IRC section 509(a)(1) and (a)(2)) or a Private Foundation. Nearly two pages of the Instructions explain those classifications. To oversimplify, a Public Charity receives its contributions and revenue from many donors, unlike a Private Foundation that is controlled by its major donor. (Note that Supporting Organizations and Private Operating Foundations are excluded by the Eligibility Worksheet.)

Part V is for existing charities seeking reinstatement after automatic revocation for three years' failure to file tax returns.

When signing the online return, an officer of the charity checks a final box for the penalty-of-perjury declaration.

### **4. PUSHING THE EZ BUTTON**

#### **A. EXPERT RECOMMENDATION: DON'T DO IT**

In January 2012, the National Taxpayer Advocate's Annual Report to Congress broached the idea of a shorter Form 1023-EZ for smaller charities, particularly to facilitate reinstatement of tax-exempt status after revocation due to failing to file tax returns for three consecutive years. See pages 562-65 in [http://www.irs.gov/pub/tas/2011\\_arc\\_legrecommendations.pdf](http://www.irs.gov/pub/tas/2011_arc_legrecommendations.pdf)

In 2012, the regular Form 1023 and proposed Form 1023-EZ were analyzed by the IRS Advisory Committee on Tax Exempt and Government Entities, which issued its 41-page report on June 6, 2012. After interviewing IRS officials, practitioners, and state charity regulators, the Advisory Committee declined to recommend Form 1023-EZ. Its primary reason was that "Form 1023 serves an important educational purpose for applying organizations. Through its questions, the form forces the applying organization to think somewhat deeply about its activities, finances, and management." Moreover, "it would be difficult to design a significantly shorter Form 1023-EZ that would still be effective from the IRS's perspective, i.e., that it would still provide the IRS with all the essential information it needs to make a determination on a small

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organization's exempt status." The Advisory Committee noted that "[s]tate charity regulators uniformly oppose a Form 1023-EZ, noting that such a form would make it easier for "scam" charities to obtain Section 501(c)(3) status." While acknowledging the burden of the regular Form 1023 on small charities, the Advisory Committee pointedly observed that "if projected annual gross receipts were used as the threshold for Form 1023-EZ, there would be a natural inclination for organizations to understate those projections." Report pages 31-33 (pdf pages 103-105), in [http://www.irs.gov/pub/irs-tege/tege\\_act\\_rpt11.pdf](http://www.irs.gov/pub/irs-tege/tege_act_rpt11.pdf)

As for the regular Form 1023, the Advisory Committee recommended some restructuring. But overall it recognized that the regular Form 1023 impelled new charities to learn the Federal tax requirements for tax-exempt status. No matter how much the IRS simplified Form 1023, the underlying matrix of Federal and state laws regulating charities would remain just as complex as before.

The regular Form 1023 is analogous to basic training for military recruits: an arduous program that instills essential knowledge, while incidentally discouraging or weeding out those unprepared for the rigors of running a charity. For officers and directors of a charity, such training is not merely a good idea, but is valuable protection against Federal or California penalties for excess benefit transactions or other regulatory violations.

## **B. IRS FORGES AHEAD ANYWAY**

Just 12 months later, in June 2013, IRS disregarded the Advisory Committee's analysis, and resuscitated the Form 1023-EZ proposal. As a pilot project, it tested the concept in expedited review of backlogged regular Form 1023s. The draft Form 1023-EZ emerged on March 31, 2014.

Meanwhile, the IRS backlog of pending Form 1023 applications had increased by 500 percent during 2013, according to IRS Commissioner John Koskinen. That increase was astounding, given that review of Form 1023 was often slow before 2013. A key argument in favor of Form 1023-EZ is that it will reduce the backlog of pending applications, while allowing the IRS to focus on selected applications.

Despite critical comments from practitioners, state charity regulators, and charity watchdogs, the IRS finalized Form 1023-EZ on July 1, 2014. In response to those comments, the IRS did reduce the gross-receipts ceiling from \$200,000 to \$50,000 -- for whatever that is worth.

## **C. RUBBER STAMP -- OR LIBRARY CARD?**

Surprisingly, this revision of a specialized IRS form attracted the attention of TIME magazine, in a July 13, 2014 article entitled "IRS to Rubber-Stamp Tax-Exempt Status for Most Charities After Scandal". IRS Commissioner John Koskinen explained that the new short form would enable the IRS to clear its year-long backlog of 66,000 exemption applications. Opponents of Form 1023-EZ reiterated their concerns about fraud and "dark political money." President Tim Delaney of the National Council of Nonprofits complained that "it's easier to get tax-exempt status under 1023-EZ than it is to get a library card." Therefore, fraudsters "will be able to operate in the name of the charity, and the IRS will never be the wiser because they're not looking at the underlying documentation." <http://time.com/2979612/irs-scandal-tax-exempt-tea-party-political-groups-john-koskinen/>

The backdrop of "scandal" is the controversial IRS handling of IRC section 501(c)(4) applications (Form 1024) of Tea Party organizations. In May 2013, IRS Exempt Organizations Director Lois Lerner asserted her Fifth Amendment privilege before Congress, and soon retired. Soon thereafter, the IRS was gearing up for Form 1023-EZ. Perhaps the IRS correctly anticipated that the ensuing commotion in the Exempt Organizations Division would slow the processing of regular Form 1023 applications by charities. That slowdown created a huge backlog that necessitated the drastic remedy of Form 1023-EZ. Whatever the linkage, that scandal is beyond the scope of this article.

## **5. SMURFING FOR TERRORISTS**

One example of the laxity of Form 1023-EZ is grants to foreign organizations. A yellow-flag question asks merely whether the charity will conduct foreign ac-

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tivities or make grants to foreign organizations. If the charity answers Yes, it does not have to provide any details about what activities or which foreign countries are planned. By contrast, regular Form 1023, Part VIII, items 12 and 14 require extensive details about foreign activities and grantmaking.

As noted above, the ceiling of \$50,000 of projected gross receipts for Form 1023-EZ is dubious because of the inherent uncertainty in estimating future contributions from donors. That defect is compounded because Form 1023-EZ does not ask whether multiple small charities are being operated under common management. (Compare Form 1023, Part VIII, Item 15.) In money laundering parlance, recruiting numerous persons to make transactions that each fall below the reporting threshold is called "smurfing".

In a worst-case scenario, supporters of foreign terrorists could set up multiple U.S. charities - smurfs - listing different officers and directors, but actually under common management. Each charity would be eligible for Form 1023-EZ based on its standalone projected gross receipts of less than \$50,000. Each charity would check "Yes" concerning foreign grantmaking. It could describe itself with an innocuous-sounding NTEE code like Q33 "International Relief". Unless it chose a brazen name like "San Diego County Friends of Da'esh," it could probably slide through under the radar. If indeed its gross receipts were under \$50,000, it could maintain a low profile by annually filing only the 1-page IRS Form 990-N return for Public Charities.

## **6. FUTURE REFORM OR REPEAL**

If the IRS decides to tighten up Form 1023-EZ, it could start by adding additional questions to the Eligibility Worksheet -- concerning common management of multiple charities, or grantmaking to specified countries, for instance. It could revise the Form itself to make unincorporated associations ineligible, because their governing documents are generally not on file with any government office.

In addition, the IRS could follow up with charities that filed Form 1023-EZ. It might require those charities to file the long Form 990 annual return every two or three

years, for example, in order to gather more information about the charity's actual activities. If a charity exceeded \$50,000 of gross receipts in any of its first 3 years, it could be charged the \$450 filing fee differential between Form 1023-EZ and regular Form 1023, and perhaps be required to file the regular Form 1023.

State charity regulators could take the initiative to find out more about new charities by requiring each registered charity to provide either a copy of its regular Form 1023 or else a detailed application resembling Form 1023. Charity watchdogs could encourage new charities to provide supplemental disclosures in lieu of Form 1023.

Ultimately, after the IRS clears its backlog of exemption applications, it might replace Form 1023-EZ by developing a streamlined Form 1023, filed online. Or perhaps Form 1023-EZ would provide only a short-term exemption, like a provisional patent, that could only be extended by filing the long-form application.

For now, many new genuine charities can save time, effort, and money by filing Form 1023-EZ. Their directors and officers still ought to spend substantial time and effort learning about Federal and State laws regulating charities -- maybe using regular Form 1023 as a study guide. Ultimately it is in their own interest to learn how to comply with Federal and State charity law, because otherwise they could be personally liable for penalties.

As for attorneys and other philanthropy professionals, the displacement of regular Form 1023 by new Form 1023-EZ underscores their obligation to inform prospective founders of charities about the burdens and responsibilities that lie ahead.

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