Preserving a Charitable Exemption

BY LOUIS E. MICHELSON

Money is the fuel that runs the engine for charitable organizations. To that end, the nation's tax laws are structured to encourage people to be generous in making charitable donations. The Internal Revenue Code allows a taxpayer to deduct money that is given to a charity (26 U.S.C. § 170), and with this obvious enticement to donors, every charitable organization in America rightfully cherishes its tax-exempt status.

Until recently, it was rare to see a charity lose its treasured tax exemption. Typically, revocation occurred only in cases involving seriously bad behavior—just desserts for "private inurement" or inappropriate self-dealing.

However, revocations may become much more frequent due to a little-known provision of the Pension Protection Act of 2006 (PPA) (Pub. L. No. 109–208). Until its enactment, smaller charities with annual gross receipts below $25,000 did not have to file a tax return. All that has changed as the PPA mandates that smaller charities electronically file Form 990-N, a streamlined return commonly referred to as the "e-postcard" (see IRS Publication 4752, available at www.irs.gov/pub/irs-pdf/p4752.pdf; 2009 WL 2176066 (Treasury Dept. regulations)). Charities with more than $25,000 in gross receipts are required to file either Form 990-EZ or Form 990, depending on their level of gross receipts and total assets.

NEW DANGER FOR CHARITIES

Although the PPA took effect just four years ago, the ax has already fallen on some organizations and is about to fall on others. But why should anyone worry about a streamlined filing requirement that is easy to comply with? Form 990-N can only be filed electronically, and it requires very little information about the nonprofit (only eight questions appear on the one-page form). However, filing is not the issue. The problem is that the PPA requires continuous filing—every tax year. Any charity, regardless of size, that does not file a return—whether Form 990-N, Form 990, or Form 990-EZ—for three consecutive years may become a target for revocation.

Practitioners should not assume that the loss of exempt status is a temporary problem. A charity's tax-exempt status will not be magically restored once delinquent returns are filed. These revocations are final.

And if any charities harbor the belief that a "good faith" excuse for not filing will get them off the hook, they need to think again. The IRS has stated that the PPA does not give them discretion to do anything but revoke the offending organization's exemption. It is uncertain whether any procedural action can be taken to reverse a revocation based on the failure to file a return.

The only practical remedy is to return to square one and reapply to the IRS to obtain new recognition of tax-exempt status. This means the charity must start over with a brand new exemption application (Form 1023), expending the time and effort involved in that process. This includes a new (and increased) IRS user fee of $850 with its application submission, unless the charity qualifies for the reduced user fee of $400 for organizations with annual gross receipts totaling no more than $10,000 during the four years preceding the exemption application.

The IRS is not bound to grant exempt status to a formerly tax-exempt charity. The organization may hope and even expect that its prior history of good works will be helpful in reestablishing its exempt status; however, nothing requires the IRS to favor nonprofit groups based on their former status. It is therefore imperative that all nonprofits pay close

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attention to the reporting rules.

(To its credit, the IRS has not been completely heartless when it comes to out-of-compliance charities. Last year, for example, the agency offered a one-time relief program for small nonprofit organizations at risk of losing their tax-exempt status because they had failed to file the required returns. However, that window is now closed—the deadline for submitting the missing returns was October 15, 2010.)

RELIGIOUS ENTITIES

Not every nonprofit group must report. The requirements discussed above do not apply to churches or synagogues and similar entities, which are not required to file tax returns, even of an informational nature. (26 U.S.C. § 6033(a)(2)(A).) The church exemption, however, does not apply to all religious organizations. Indeed, many religion-related entities are required to file Form 990, Form 990-EZ, or Form 990-N. (See IRS Publication 1828, Tax Guide for Churches and Religious Organizations.)

The distinction between "churches" and "religious organizations" has been shaped by Congress, the IRS, and the courts. A church is defined more narrowly than a religious organization partly because churches generally conduct sacerdotal functions that other religious organizations do not. Although the IRS has developed a 14-factor test, the critical element is that a church includes a body of believers that assemble regularly in order to worship. (See *Found. for Human Understanding v. United States,* 88 Fed. Cl. 203 (2009).) To assist taxpayers, the 501(c)(3) determination letter issued by the IRS usually indicates how an organization is classified and whether Form 990 is required.

Loss of a federal charitable exemption may trigger a number of serious problems. In addition to drying up contributions from individual donors, it may also jeopardize the organization's funding from grant-makers. It could also trigger the loss of a state income tax exemption. In fact, the charity's loss of its state tax-exemption status may be automatic if it is conditioned on the continuing existence of a federal exemption.

For smaller charities in California, there is more to worry about than just the federal e-postcard. A similar form now must also be submitted to the Franchise Tax Board, as California has aligned its filing requirements with the federal procedure; thus, beginning January 1, 2011, any organization that fails to file a state tax return for three consecutive years will automatically lose its California tax-exempt status. (See www.ftb.ca.gov/professionals/taxnews/2010/July/Article_8.shtml.)

FOCUS ON GOVERNANCE

At the same time the IRS has stepped up enforcement of its filing requirements, it has also dramatically increased the focus on the internal governance of nonprofits. The IRS believes that a "well-governed charity is more likely to obey tax laws, safeguard charitable assets and serve charitable interests than one with poor or lax governance."

The key leadership principles it advocates are found in the governance section of the Life Cycle tool on the IRS Exempt Organization website (www.irs.gov/pub/irs-tege/governance_practices.pdf).

As Commissioner Sarah Ingram has noted, these principles also are embedded in Part VI of the new Form 990, the annual information reporting form used by nonprofit organizations. (See Prepared Remarks (June 23, 2009) www.irs.gov/pub/irs-tege/ingram__gtown__governance_062309.pdf.) The new Form 990 contains a complete section on governance consisting of three parts: composition of the organization's governing body, its governance and management policies, and its disclosure practices. (Form 990-EZ and Form 990-N contain no similar section on governance.)

THE COMPLIANCE BURDEN

Seemingly straightforward questions about governance may be more involved than they appear. Consider Question 1b on Part VI of Form 990. It asks the organization to state, as of the end of the tax year, the number of independent voting board members. The complicated part is the IRS's definition of *independent*.

For example, a board member who has worked during the year as an officer or employee of the nonprofit is not independent, at least according to the IRS. On the other hand, a board member can receive separate compensation as an independent contractor up to $10,000. Furthermore, as long as any payment to the director for services solely as a director is reasonable, the director can pass muster as independent because such payments don't count toward the $10,000 independent-contractor total.

But regardless of their compensation, board members can lose their independent status if they are involved in transactions with the organization that must be reported on Schedule L (Transactions With Interested Persons). The reporting rule also covers transactions by the board member's family and transactions done indirectly through an affiliated entity.

The good news here is that the IRS Instructions to Form 990 state that an organization need only engage in a "reasonable effort" to obtain the necessary information. For example, the organization may rely on an appropriately worded annual questionnaire to each of its officers, directors, trustees, and key employees. (See www.irs.gov/pub/irs-pdf/i990.pdf.)

MANAGEMENT POLICIES

Form 990 also requests information about management policies and disclosure practices. Like many IRS forms, boxes marked "yes" and "no" follow each inquiry. Some charities and their accountants believe that the goal should be to answer each question affirmatively, essentially telling the IRS that "Yes, we have such a policy." Answering "no" can subject a nonprofit or its managers to uncomfortable questions should the organization be audited.

Consequently, in order to avoid raised eyebrows, many organizations will utilize standard, preprinted policies just to make sure they have something in place. But that strategy may backfire if the procedures are not implemented and followed.

The key is for every charitable organization to establish and thereafter follow an individualized approach to governance. For that reason, each charity should consider the organization's size, type, and culture when evaluating whether to adopt or revise a given policy. The board of directors should be engaged and informed because, in the end, they are the ones responsible for the conduct of the organization's affairs.

EMPLOYMENT AUDITS

Last February the IRS commenced an Employment Tax National Research Project, which for the first time will include exempt organizations.

The project will focus on four employment tax-compliance issues: (1) worker classification as employees or independent contractors, (2) reasonableness of executive compensation, (3) employee reimbursements, and (4) fringe benefits.

These audits present additional risks for charitable organizations because IRS agents may delve into other employment-related tax issues. It is not inconceivable that an agent might inquire about the reasonableness of compensation. That question, in turn, might trigger scrutiny of the economic benefits being paid to executives, which could lead to an investigation into the use of property, foregone interest on loans, and deferred compensation—all of which are treated as taxable.

If unreasonable in the aggregate, such compensation can be deemed an "excess-benefit transaction"—in which the charitable organization pays economic benefits over and above the value of the services provided by the executive. If that is the case, the executive could be subject to a 25 percent initial excise tax on the excess benefits. In addition, any officer, director, or trustee who participated in the transaction could be subject to another excise tax equal to 10 percent of the excess benefit, up to $20,000 per transaction. There is joint and several liability for this second tax. (See 26 U.S.C. § 4958.)

The excess benefit transaction rules might also apply to employee expense reimbursements. Under the IRS regulations, expense reimbursements are deemed reportable (and taxable) income, unless they are paid pursuant to an "accountable plan," which means: the expenses must have a business connection; employees must substantiate them; and employees who receive advances must agree to return payments that are not substantiated. (See Treas. Reg. § 1.62(c)(2).) But charities should be careful with their reimbursements. If an organization reimburses an employee's legitimate expenses but fails to contemporaneously document that the parties intended to treat the payment as compensation (such as including the reimbursement as income on Form W-2), the payment may give rise to an excise tax; payment may be treated as an "automatic excess-benefit transaction." This treatment applies regardless of whether the benefits were reasonable. (Treas. Reg. § 53.4958-4(c)(1).)

Given these risks, charitable organizations should consider conducting an internal review of their compensation practices to be sure they are appropriate.

> Revocations of charities' tax-exempt status may become much more frequent due to a little-known provision of the Pension Protection Act of 2006.

CALIFORNIA REGISTRATION

In addition to complying with federal regulations, charities must also comply with state procedures—and that means dealing with the attorney general's office, which oversees charities in California. In this state, charities must register and report annually to the attorney general. (See Cal. Gov. Code §§ 12580–12599.7) Charities that have fallen behind in their annual reporting should be aware that the AG's office has modernized its records and is starting to target noncompliant entities.

The new enforcement approach expands beyond the historic practice of sending out delinquency letters. Now, the AG's office will take the additional step of notifying the Franchise Tax Board (FTB) that the charity's registration is being suspended. Once the FTB receives such a notice, it hits the offending charity in the pocketbook by assessing California's minimum franchise tax (currently $800 per year). (See Cal. Rev. & Tax Code § 23703.)

Essentially, the FTB is acting as a collection agency for the state of California. Once the minimum tax is imposed, the FTB does not have discretion to waive or abate the levy. Even if the charity gets back into compliance with its annual reporting, there is no mechanism in place to erase the liability for these taxes.

A charity should not ignore the taxes imposed by the FTB. Nonpayment could lead to another problem: suspension of the organization's corporate status. Once that occurs, the entity cannot legally transact business, and it cannot engage in fund-raising or defend itself in court. A suspended corporation could also lose the right to use its own name.

In the end, the solution to all of these problems is to prevent them from occurring in the first place: Every charity should check to see that it is current with tax filings and other registrations and that internal protocols comply with legal requirements. Doing so will avoid a lot of grief.

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1 After three consecutive years of failing to file a tax return, revocation of tax-exempt status is automatic.
❑ True ❑ False

2 Only small charities are targets for revocation of tax-exempt status.
❑ True ❑ False

3 Charities whose tax-exempt status has been revoked must pursue a brand new IRS application to obtain a tax exemption.
❑ True ❑ False

4 If a new IRS application is filed within six months of revocation, the government is obligated to grant renewed tax-exempt status.
❑ True ❑ False

5 The IRS view is that a well-governed charity is more likely to obey tax laws, safeguard charitable assets, and serve charitable interests than one with poor or lax governance.
❑ True ❑ False

6 The key IRS principles on governance can be found in the governance section of the Life Cycle tool on the IRS Exempt Organization website.
❑ True ❑ False

7 A specific section of the new Form 990 is devoted to the governance of charitable organizations.
❑ True ❑ False

8 One question on Form 990 requires a charity to state how many voting members of its governing body are independent.
❑ True ❑ False

9 To be considered an independent board member, a director must not have received compensation exceeding $10,000 as an independent contractor for non-director services during the organization's tax year.
❑ True ❑ False

10 An organization is required to make reasonable efforts to obtain the governance information required by Form 990.
❑ True ❑ False

11 An organization may rely on information obtained from a questionnaire distributed annually to officers, directors, trustees, and key employees.
❑ True ❑ False

12 California recently conformed to federal law regarding the annual filing requirement for smaller charities.
❑ True ❑ False

13 If reimbursement expenses are not properly documented, they can result in an excess-benefits transaction.
❑ True ❑ False

14 The new Form 990 contains a complete section on governance.
❑ True ❑ False

15 The IRS will likely focus on whether a charitable organization properly classifies workers as employees or as independent contractors.
❑ True ❑ False

16 The IRS will audit exempt organizations as part of its Employment Tax National Research Project.
❑ True ❑ False

17 Employment audits present additional risks for charitable organizations because IRS agents may consider a variety of employment-related tax issues unique to charities.
❑ True ❑ False

18 In California, charities must register and report annually to the attorney general's office.
❑ True ❑ False

19 The attorney general's office has modernized its records and is targeting charities that have fallen behind in their annual reporting.
❑ True ❑ False

20 Once the Franchise Tax Board receives a notice that the attorney general is suspending a charity's registration, it may assess a minimum annual tax of $800.
❑ True ❑ False

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