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New IRS Rule Allows Organizations to Rely on Pre-Incorporation Determination Letter

by Rosalie Westenskow, Atkin & Associates, Eugene, Oregon

One of the IRS's most recently released Revenue Procedures contains new rules that make it easier for practitioners to convince 501(c) tax-exempt clients to incorporate. In the nonprofit world, where many groups function on trust and run on volunteer power, it is not uncommon for an unincorporated association to obtain tax-exempt status, with its founders assuming there is no need for the formality of incorporation. However, as the years progress and the association extends its operations, it will likely have many reasons to incorporate; primarily, it will struggle to enter business transactions, such as contracting for services, without being a corporate entity. Unfortunately, these groups may be reluctant to incorporate their previously unincorporated voluntary association, because in the past, doing so also meant filing an application for tax exemption with the IRS. The expense and time associated with filing a new application could be a deterrent for some small groups. However, Revenue Procedure 2018-15 changes this.

Historically, the IRS required that any 501(c) organization that underwent significant changes to its structure after receiving its determination letter must reapply for tax-exempt status. *See* Rev. Proc. 2018-5, 2018-1 I.R.B. § 11.02. In order to become tax exempt initially, an organization must file the appropriate form with the IRS and receive a determination letter from the agency recognizing its status. 26 C.F.R. § 1.501(a)-1(a)(2). Once that determination of tax-exempt status has been granted, the organization can continue to rely on that determination unless there are "substantial changes" to the organization's "character, purposes, or methods of operation"; in that case, the organization must reapply for tax-exempt status in some cases. *Id.*

In the past, the IRS interpreted a "substantial change" in the organization's "character" and "methods of operation" to include the following changes to an organization's structure, all of which required reapplication for tax exemption: "(1) incorporation of a trust; (2) incorporation of an association; (3) reincorporation by an Act of Congress; and (4) reincorporation under the laws of another state." Rev. Proc. 2018-15, 2018-9 I.R.B. § 2, *citing* Rev. Rul. 67-390, 1967-2 C.B. 179; Rev. Rul. 77-469, 1977-2 C.B. 196; Tax Exempt Status for Your Organization, IRS Pub. No. 557 (Jan. 2018). The IRS viewed the shift from unincorporation to incorporation as the creation of a new entity. Rev. Rul. 77-469, 1977-2 C.B. 196. As such, the IRS did not allow the old organization to shift tax-exempt status to the "new" organization.

At the same time, though, the IRS often did not require these organizations to obtain a new EIN—a contradictory rule if the now incorporated organization was indeed a "new" entity in the eyes of the IRS. To be specific, the IRS does not require a new EIN in the following situations: (1) Under state law, when one corporation merges into another corporation, the surviving corporation can continue to use its old EIN. Rev. Rul. 73-526, 1973-2 C.B. 404. (2) An organization incorporated under one state's laws that reincorporates in another state can continue to use the same EIN. *Id.* (3) After a corporate reorganization in which the corporation only changes its identity, form, or place of organization, no new EIN is required. Employer Identification Number, Understanding Your EIN, IRS Pub. No. 1635 (Feb. 2014).

However, Revenue Procedure 2018-15 now allows an organization that was unincorporated when it received its determination letter, but subsequently incorporated, to continue to rely on its original determination letter if it meets certain requirements. Rev. Proc. 2018-15, 2018-9 I.R.B. § 5.01. In order to qualify for this new rule, the restructuring entity must be a business entity classified as a corporation under 26 C.F.R. § 301.7701-2(b)(1) or (2). *Id.* A corporation as defined in 26 C.F.R. § 301.7701-2(b)(1) or (2) is either 1) a business entity that is organized under a federal or state statute, or that of a federally recognized Indian tribe, if that statute refers to the entity as being incorporated or as being a "corporation," "body corporate," or "body politic"; or 2) an association, as defined under 26 C.F.R. § 301.7701-3.

In addition, the entity must be recognized as tax exempt under section 501(a) as an organization described in section 501(c), and the incorporated entity must continue to carry out the same purposes as the original tax-exempt entity. Rev. Proc. 2018-15, 2018-9 I.R.B. § 5.01. The original tax-exempt entity must also have been in good standing in the state where it was originally formed. *Id.* § 5.02. If it is a 501(c)(3) organization, the surviving entity's Articles of Incorporation must continue to meet the organizational test of 26 C.F.R. § 1.501(c)(3)-1(b), including the requirements governing the distribution of assets upon dissolution in § 1.501(c)(3)-1(b)(4). *Id.* § 5.04. Neither the original nor the new organization may be a disregarded entity, limited liability company, partnership, or foreign business entity. *Id.* Lastly, the surviving organization cannot have obtained a new EIN. *Id.*

The text of Revenue Procedure 2018-15 does not state whether or not the rule applies retroactively. However, as our firm has worked with clients who want to take advantage of this new rule, we have talked with IRS agents to clarify applicability to our clients. According to our conversations with IRS agents, the rule does apply retroactively, meaning that an organization that both received its original determination letter and incorporated before Revenue Procedure 2018-15 was issued can still take advantage of the new rule and rely on its original determination letter without having to reapply for tax-exempt status.

This new rule will hopefully eliminate redundancy, because the IRS already requires organizations to report significant organizational changes on their annual Form 990. Rev. Proc. 2018-15, 2018-9 I.R.B. § 2; *see also* 2017 Instructions for Form 990 Return of Organization Exempt from Income Tax (Jan. 2018). In the past, this did not include incorporation, but presumably the new 2018 Form 990 Instructions will be updated to reflect this new rule and organizations will simply alert the IRS to incorporation on Part VI, line 4 of Form 990. In addition, this rule aligns more precisely with IRS requirements on when entities must obtain a new EIN after restructuring. *See* Rev. Proc. 2018-15 § 2.

For practitioners, the change is a welcome reduction in red tape for our clients that need to progress or change through incorporation or reincorporation in another state.

Update on the Ever-Increasing Charitable Substantiation Rules

"I just filled out my income tax forms. Who says you can't get killed by a blank?"
– Milton Berle

by Jeffrey C. Thede and Justine C. Thede, Thede Culpepper Moore Munro & Silliman LLP, Portland, Oregon

The charitable gift substantiation rules have befuddled donors and even the most experienced of advisors for years. Some of these rules were clarified in long-awaited final regulations issued on July 30, 2018, but practitioners who had hoped for some degree of latitude in the final rules, particularly with regard to qualified appraisals, likely will be disappointed. Given the complexity of the substantiation rules and the number of recent cases denying deductions entirely for even the most minor of nonconformities, a brief refresher on the basic rules may serve useful even to those who regularly advise on charitable giving.[1]

Since 1982, Congress has imposed increasingly demanding reporting standards for charitable deductions, largely in response to perceived abuses by taxpayers. Most recently, the American Jobs Creation Act of 2004 imposed additional substantiation requirements for noncash contributions of property with a value of more than $500,[2] and the Pension Protection Act of 2006 ("PPA") added recordkeeping requirements applicable to all cash contributions regardless of value.[3] The PPA also codified the qualified appraisal rules that previously were found only in the regulations.[4] Notice 2008-16 provided guidance on the new rules, and these proposed rules have now been adopted as final regulations with minimal changes.[5]

Section 170(a)(1) of the Code[6] allows a deduction for a charitable contribution only if such contribution is "verified under regulations prescribed by the Secretary." The size and nature of a particular contribution determine which verification rules under section 170 apply.

Substantiation Rules in a Nutshell

<u>All</u> cash contributions – donee receipt or bank record;[7]

Cash contributions of $250 and above – contemporaneous written acknowledgment;[8]

<u>All</u> noncash contributions – donee receipt or "reliable records";[9]

Noncash contributions of $250 or more – contemporaneous written acknowledgement;[10]

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1 This article is intended to provide only a brief discussion of the substantiation requirements applicable generally to cash and noncash contributions. It does not discuss the various exceptions and special rules applicable to certain categories of property (e.g., clothing and household items, art, vehicles, conservation easements, publicly-traded securities and other readily valued property, payroll deductions, etc.).

2 I.R.C. § 170(f)(11).

3 I.R.C. § 170(f)(17).

4 I.R.C. § 170(f)(11)(E).

5 Treas. Reg. §§ 1.170A-15 (cash contributions), 1.170A-16 (noncash contributions), 1.170A-17 (definitions of qualified appraisal and qualified appraiser), and 1.170A-18 (contributions of clothing and household items).

6 Unless otherwise specified, references to the "Code" are to the Internal Revenue Code of 1986.

7 I.R.C. § 170(f)(17).

8 I.R.C. § 170(f)(8)(A)-(C); Treas. Reg. § 1.170A-13(f).

9 Treas. Reg. § 1.170A-13(b)(1).

10 I.R.C. § 170(f)(8)(A); Treas. Reg. § 1.170A-13(f).

Noncash contributions of $501 to $5,000 – Form 8283 (Section A);[11]

Noncash contributions in excess of $5,000 – qualified appraisal and appraisal summary Form 8283 (Section B);[12]

Gifts of artwork in excess of $20,000 – qualified appraisal attached to taxpayer's return; and

Noncash contributions in excess of $500,000 – qualified appraisal attached to taxpayer's return.[13]

Cash Contributions

To claim a charitable deduction for any contribution of cash, regardless of the amount, the donor must maintain a record of the gift in the form of a bank record or a written communication from the donee.[14] The record must show the donee's name, the date of the contribution, and the amount of the contribution. Under the final regulations, an e-mail from the donee containing the necessary information is satisfactory, but a blank pledge card is not.

A deduction for a cash contribution of $250 or more requires a receipt (a "contemporaneous written acknowledgement") from the donee, which must include (1) a description of the cash or other property contributed and the date of contribution and (2) either (a) a good faith estimate of any goods or services provided in connection with the gift or (b) a statement that no goods or services were provided.[15] The acknowledgement must be received by the donor before the earlier of the date of filing the donor's tax return on which the deduction is claimed or the due date (including extensions) for filing the return. The new regulations confirm that for cash contributions of $250 or more, both the receipt and contemporaneous written acknowledgement requirements may be satisfied in a single document.[16]

These rules rarely are a problem in the case of gifts to public charities, which generally issue acceptable receipts as a matter of course, but the IRS does not take kindly to receipts that do not contain all the required information.[17]

Noncash Contributions

As with the substantiation requirements applicable to cash gifts, no charitable deduction is allowed for a noncash contribution of any amount unless the donor obtains a receipt from the donee organization showing the name and address of the donee, the date of the contribution, and a description of the property in sufficient detail to meet the requirements of section 1.170A-16(a)(iii).[18] For noncash contributions of $250 or more, the taxpayer must obtain a contemporaneous written acknowledgment from the donee.[19]

If deducting a contribution of more than $500 but not more than $5,000, the donor must also complete Section A of IRS Form 8283 ("Noncash Charitable Contributions") and file it with the return on which the deduction is claimed.[20]

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11 I.R.C. § 170(f)(11)(B); Treas. Reg. § 1.170A-13(b)(3) .

12 I.R.C. § 170(f)(11)(C); Treas. Reg. § 1.170A-13(c).

13 I.R.C. § 170(f)(11)(D).

14 I.R.C. § 170(f)(17).

15 I.R.C. § 170(f)(8)(A)-(C); Treas. Reg. § 1.170A-13(f).

16 Treas. Reg. § 1.170A-15.

17 *See, e.g., Durden v. Comm'r*, T.C. Memo 2012-140; *DiDonato v. Comm'r*, T.C. Memo 2011-153.

18 Treas. Reg. § 1.170A-13(b)(1). The final regulations provide an exception if it is impracticable for the donor to obtain a receipt from the donee, such as in the case of dropping off household items at a charity's drop-box. In such a case, the donor must maintain "reliable written records" as defined in the regulations. Treas. Reg. § 1.170A-16(a)(2)(iii).

19 I.R.C. § 170(f)(8)(A); Treas. Reg. § 1.170A-13(f). For noncash contributions, the acknowledgement must contain a description of the property but not the value.

20 I.R.C. § 170(f)(11)B); Treas. Reg. §§ 1.170A-13(b)(3), 1.170A-16(c).

For purposes of determining the value threshold for noncash gifts in excess of $500, similar items of property contributed during the taxable year are aggregated, whether or not donated to the same organization.[21]

Qualified Appraisals

In addition to the contemporaneous written acknowledgement described above, a donor claiming a noncash contribution of $5,000 or more must obtain a "qualified appraisal" prepared by a "qualified appraiser" and attach a signed "appraisal summary" (Section B of IRS Form 8283) to the return on which the deduction is claimed.[22] A deduction for a gift of artwork with a claimed value of more than $20,000, or other noncash contribution of more than $500,000, will be allowed only if the taxpayer attaches the qualified appraisal to the return on which the deduction is claimed.[23]

Under the new regulations, a "qualified appraisal" is an appraisal that is prepared by a qualified appraiser in accordance with "generally accepted appraisal standards," which is defined as "the substance and principles of the Uniform Standards of Professional Appraisal Practice, as developed by the Appraisal Standards Board of the Appraisal Foundation."[24] The regulations require that a "qualified appraisal" must contain a variety of detailed information, including many items not generally included in appraisals. Specifically, a qualified appraisal must contain <u>all</u> of the following:[25]

- A description of the property in sufficient detail for a person who is not generally familiar with the type of property to ascertain that the property that was appraised is the property that was (or will be) contributed;
- In the case of real property or tangible personal property, the condition of the property;
- The "valuation effective date" (i.e., the date to which the value opinion applies, which must be no earlier than 60 days before the date of contribution and no later than the date of contribution);[26]
- The fair market value of the contributed property on the valuation effective date;
- The terms of any agreement that restricts the donee's right to use or dispose of the property, reserves to or confers upon any person the right to the income from or possession of the property (such as charitable remainder trusts, pooled income funds, and charitable gift annuities), or earmarks the property for a particular use;
- The date, or expected date, of the contribution;
- The name, address, and taxpayer identification number of the appraiser and the appraiser's employer (if any);
- The appraiser's qualifications to value the type of property being valued, including the appraiser's education and experience;
- The signature of the appraiser and the date signed by the appraiser;
- The following declaration by the appraiser: "I understand that my appraisal will be used in connection with a return or claim for refund. I also understand that, if there is a substantial or gross valuation misstatement of the value of the property claimed on the return or claim for refund that is based on my appraisal, I may be

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21 Treas. Reg. § 1.170A-13(c)(1)(i).
22 I.R.C. § 170(f)(11)(C); Treas. Reg. §§ 1.170A-13(c), 1.170A-17(d).
23 I.R.C. § 170(f)(11)(D).
24 Treas. Reg. § 1.170A-17(a)(2).
25 It is worth noting that in the authors' review of well over 100 supposedly "qualified" appraisals, only two met all the applicable requirements.
26 Treas. Reg. § 1.170A-17(a)(5)(i).

subject to a penalty under section 6695A of the Internal Revenue Code, as well as other applicable penalties. I affirm that I have not been at any time in the three-year period ending on the date of the appraisal barred from presenting evidence or testimony before the Department of the Treasury or the Internal Revenue Service pursuant to 31 U.S.C. 330(c)";

- A statement that the appraisal was prepared for income tax purposes;
- The method of valuation used to determine the fair market value, such as the income approach, the market-data approach, or the replacement-cost-less-depreciation approach; and
- The basis for the valuation, such as specific comparable sales transactions or statistical sampling, including a justification for using sampling and an explanation of the sampling procedure employed.[27]

An appraisal will not be considered a "qualified appraisal" unless it is signed and dated by the qualified appraiser no earlier than 60 days before the date of the contribution and no later than the due date (including extensions) of the return on which the deduction is first reported or, in the case of a deduction first claimed on an amended return, the date on which the amended return is filed. Further, the fee for a qualified appraisal cannot be based to any extent on the appraised value of the property.[28]

Finally, the proposed and final regulations provide that each of the substantiation requirements that must be submitted with a return applicable to contributions of $500 or more also apply to the return for any carryover year under Code section 170(d).[29]

Qualified Appraiser

Under Code section 170(f)(11)(E) and the new regulations, a qualified appraiser must have verifiable education and experience in valuing the type of property for which the appraisal is performed.[30] This requirement is satisfied if the appraiser "(A) [s]uccessfully completed … professional or college-level coursework … in valuing the type of property … and has two or more years of experience in valuing the type of property; or (B) [e]arned a recognized appraiser designation … for the type of property."[31]

Even if an appraiser meets all the requirements described above, the individual will not be treated as a qualified appraiser unless the appraiser (1) specifies in the appraisal the appraiser's education and experience in valuing the type of property and (2) makes a declaration that the appraiser is qualified to make appraisals of the type of property being valued.

The introduction to the final regulations references several comments received by the Treasury relating to the "qualified appraiser" definition, some requesting greater leniency and others in favor of more stringent education requirements. The Treasury seems to have been fond of its original language, because the final regulations do not adopt most of these suggestions. In one modification, however, the IRS agreed with two commenters that a generally recognized professional trade organization that provides coursework can satisfy the requirement for verifiable education.[32]

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27 Treas. Reg. § 1.170A-17(a)(3).
28 Treas. Reg. §§ 1.170A-17(a)(4), 1.170A-17(a)(9).
29 Treas. Reg. § 1.170A-16(f)(3).
30 Treas. Reg. § 1.170A-17(b)(1).
31 Treas. Reg. § 1.170A-17(b)(2)(i) (emphasis added).
32 Treas. Reg. § 1.170A-17(b)(2)(ii).

Other Comments About the Final Regulations

The final regulations continue to apply only to charitable deductions for income tax purposes and are not applicable to any other federal tax purposes, including estate and gift tax. Under the gift and estate tax regulations, however, the donor must submit such data as may be requested by the IRS.[33]

Due to the additional education and experience requirements for qualified appraisers, the final rules under section 1.170A-17 apply only to contributions made on or after January 1, 2019. All other regulations apply to contributions made on or after July 30, 2018.

A self-employed appraiser may obtain an employer identification number and provide this number on the qualified appraisal instead of the appraiser's personal social security number.

The proposed regulations included a paragraph relating to the reasonable cause exception.[34] This language has been removed from the final regulations after the Tax Court stated in Crimi v. Commissioner that the reasonable cause inquiry is "inherently a fact-intensive one, and facts and circumstances must be judged on a case-by-case basis."[35] Presumably this does not affect the availability of the exception, but the regulations themselves no longer include a standard.

In a very disappointing development, the final regulations confirm that the IRS valuation tables may not be used as a substitute for a qualified appraisal in determining fair market value, even in cases in which the underlying assets consist of cash or marketable securities. So in the case, for example, of the early termination of a charitable remainder trust by means of the assignment by the life beneficiary of his or her retained interest to the charitable remainder beneficiary, a qualified appraisal must be obtained for the life beneficiary's interest (even though that interest can be valued using the same tables prescribed for gifts to the trust).

Strict Compliance

The regulations explicitly require strict compliance with each substantiation requirement as a condition of income tax deductibility. Although the Tax Court has on occasion applied the substantial compliance doctrine and granted at least a portion of a taxpayer's claimed deduction, it has far more frequently required strict compliance (even if at times begrudgingly).

In *Villareale v. Commissioner*, the Tax court denied a taxpayer's deduction for contributions made to a public charity created by the taxpayer.[36] Both the taxpayer and the charitable organization provided records showing several cash contributions of more than $250 each transferred from the taxpayer's bank account to the organization's bank account, but the charity did not provide any written acknowledgement to the taxpayer. The taxpayer argued that it would be meaningless to write herself an acknowledgement, but the court denied the charitable deduction for failure to comply with the fundamental "contemporaneous written acknowledgement" requirement.

The holding in *Durden v. Commissioner*, which also dealt with the contemporaneous written acknowledgement requirement, may have been particularly harsh.[37] In that case, the taxpayers made a $25,000 cash contribution to their church, and received a letter from the church acknowledging the contribution, but the letter did not include the

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33 Treas. Reg. §§ 20.2055-1(c), 25.2522(a)-1(c).
34 Prop. Treas. Reg. § 1.170A-16(f)(6), 73 Fed. Reg. 45908, 45917 (Aug. 7, 2008).
35 T.C. Memo 2013-51.
36 T.C. Memo 2013-74.
37 T.C. Memo 2012-140.

required statement that no goods or services were provided in consideration of the contribution. The IRS disallowed the deduction entirely. The taxpayers argued substantial compliance at the Tax Court, but the court disagreed, explaining that the "no goods or services" statement was necessary to determine the deductible amount of the contribution.

And in *Mohamed, Sr. v. Commissioner,* arguably one of the scariest substantial compliance decisions in recent years and issued just weeks after Durden, the Tax Court denied the deduction of a qualified charitable gift of real property worth more than $15 million because the appraisal provided by the taxpayer did not satisfy each of the defined requirements of a qualified appraisal.[38] And ironically, the taxpayer in this case (Mr. Mohamed) was a certified real estate appraiser.

That's not to say taxpayers have not on occasion successfully argued substantial compliance over the past decade. In *Cave Buttes, LLC v. Commissioner*, the IRS attacked a taxpayer's attached appraisal on several fronts, including its compliance with section 1.170A-13(c)(3)(ii), which requires that an appraisal include "the qualifications of the qualified appraiser who signs the appraisal."[39] Two appraisers contributed to the appraisal submitted by the taxpayer in *Caves Buttes*, but the document contained the qualifications of only one appraiser, who was also the only appraiser to sign the report. Rejecting the IRS's argument that the appraisal was deficient, the court held that the taxpayer had substantially complied with the regulations.

But despite the occasional success story, full or even partial recovery from a denied deduction for failure to comply with the substantiation rules is unpredictable at best. Courts have noted that the substantial compliance doctrine "should not be liberally applied" and that relief should be limited to situations in which a taxpayer failed to comply with an unimportant or confusing rule.[40] Given the most recent clarifications in the new regulations, we can expect that the Tax Court will be even less likely to excuse any noncompliance going forward, and advisors should continue to ensure that their clients expend the necessary time and resources to carefully comply with each of the substantiation requirements.

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38 T.C. Memo 2012-152, 103 T.C.M. (CCH) 1814. (For Judge Holmes' own summary of taxpayers' failed attempts at showing substantial compliance, see page 1819.)

39 147 T.C. No. 10 at 349 (Sept. 20, 2016).

40 *Alli v. Comm'r*, T.C. Memo 2014-15 at 54; see also *Prussner v. United States,* 896 F.2d 218, 224 (7th Cir. 1990) ("The common law doctrine of substantial compliance should not be allowed to spread beyond cases in which the taxpayer had a good excuse… for failing to comply with either an unimportant requirement or one unclearly or confusingly stated in the regulations or the statute.")

Tax Act Impacts Exempt Organizations

by William Manne, Miller Nash Graham & Dunn LLP, Portland, Oregon

Original proposals in the 2017 Tax Act (known unofficially as the "Tax Cuts and Jobs Act") had threatened to repeal or significantly restrict the Johnson Amendment (prohibiting/limiting charities from engaging in partisan activities), eliminate tax-exempt private activity bonds, further restrict donor-advised funds, repeal an unrelated business income tax exception for royalties from use of an exempt organization's name or logo, increase the excise tax on all private foundations, and convert some art museums to private foundation status. Although those provisions were not enacted, they remain on the table as Congress continues to consider additional tax changes.

The changes that were enacted will impact the exempt-organization sector by potentially affecting charitable donations, taxing the investment income of large private colleges and universities, modifying how unrelated business income is taxed, imposing new excise taxes on certain compensation and employee fringe benefit payments, and changing how organizations report some lobbying expenses.

As we go to publication, President Trump is discussing a reduction in capital gains rates, which could have an additional impact on charitable donations, and IRS, Treasury, and tax professionals are continuing to grapple with many uncertainties created by the Act's extensive changes. Looking forward, it is expected that IRS clarification of some provisions may not be forthcoming for some time, given the magnitude of the work that the Act created for the IRS, and the reduced staffing and funding currently impacting the IRS as it seeks to implement and clarify the Act.

Most provisions of the Act are effective for tax years beginning after December 31, 2017, except as noted. All statutory references are to the Internal Revenue Code, as amended, except as noted.

Charitable Contributions May Decline (or Maybe Not).

The Act caused speculation that some changes will decrease or eliminate the federal income tax benefit of making a charitable contribution and that this, in turn, will cause a decrease in contributions. The opposing position speculates that tax savings will increase net income available for charitable contributions and that this, in turn, will cause an increase in contributions. Empirical evidence from prior tax rate reductions seems to show that immediately after implementation of rate reductions there may be a slight decrease in charitable contributions, but any such decrease is short-lived and reversed over the long term. Regardless of the impact that tax rates may or may not have on donations, development directors and others involved in raising charitable funds continue to stress the importance of charities clearly communicating the importance of their missions and providing data demonstrating their success in accomplishing those objectives. Although the following changes may have an impact on donations, those involved in fundraising continue to believe that success is based on establishing an emotional connection with potential donors and demonstrating good stewardship, and that the value of the charitable deduction itself is not a primary factor.

A. Individual Income Tax Changes. As a result of doubling the standard deduction and eliminating or limiting some itemized deductions, it is expected that many individuals will no longer itemize and will, instead, file the short form 1040. This is one of the primary items of simplification in the Act. Those individuals who did not itemize will be unable to take advantage of the charitable income deduction.

B. Income Tax Rates Reduced. Reduction of the top corporate (see below) and most individual income tax rates will decrease the tax savings realized by many who make charitable contributions and are eligible for a charitable income tax deduction.

C. Individual Limitation Increased (§ 170(f)(8)(D)). The 50 percent adjusted gross income limitation for cash contributions made by individuals to public charities and certain private foundations has been increased to 60 percent. The provision automatically expires on January 1, 2026.

D. Estate Tax Exemption Doubled. This will eliminate the usefulness of the charitable estate tax deduction for many taxable estates.

Excise Tax Based on Investment Income of Private Colleges and Universities (§ 4968).

An excise tax of 1.4 percent is imposed on the net investment income of larger private colleges and universities. The tax applies to private colleges and universities with assets (other than those used directly in carrying out the institution's exempt purpose) of at least $500,000 per student and that have at least 500 students, more than 50 percent of whom are located in the United States.

Unrelated Business Taxable Income ("UBTI") Changes.

A. UBTI Separately Computed for Each Trade or Business Activity (§ 512(a)). Losses from one unrelated trade or business may no longer be used to offset taxable income derived from another unrelated trade or business. Gains and losses have to be calculated and applied separately. There is an exception for unused net operating losses ("NOLs") arising in a tax year before January 1, 2018, that are carried forward.

Unanswered questions about how this provision will be interpreted revolve around how "one unrelated trade or business" will be defined for this provision. For example: how will amounts required to be treated as UBTI (see below) be handled; how will passive investment income be treated; how will multiple activities that constitute the same type of trade or business be treated; and how will expenses be allocated, if used for more than one trade or business?

B. Tax Rate Changes May Increase or Decrease UBTI Tax Imposed. Previous corporate income tax rates ranged from 15 to 35 percent. This provision changes to a fixed rate of 21 percent in all cases.

C. The Net Operating Loss Carryback Is Modified. Most NOLs will not be eligible to be carried back (only forward), and the deduction (going forward) is limited to 80 percent of taxable income.

Compensation Changes Mirror For-Profit Deduction Disallowances.

In a surprising new approach, Congress has decided to raise additional revenue (no doubt helping to pay for tax cuts made elsewhere in the Act) and level the playing field between for-profits and tax-exempts, by forcing tax-exempt organizations to recognize the same tax penalties as their for-profit counterparts that are unable to deduct certain compensatory expenses. This is accomplished in one case by the addition of an excise tax equal to the corporate tax rate and in another by treating disallowed expenses as UBTI.

A. Excise Tax on Excess Tax-Exempt Organization Executive Compensation (§ 4960). Tax-exempt organizations (under Sections 501(a) [entities described in Section 501(c), or (d), or 401(a)]; Section 521(b)(1) [farmers' co ops]; Section 115 [state or local governments or instrumentalities]; or Section 527(e)(1) [political organizations]—each an "applicable tax-exempt organization") will be subject to an excise tax at the corporate income tax rate (21 percent) on the sum of: (1) remuneration (other than an excess parachute payment) in excess of $1 million paid to a "covered employee" in any tax year; and (2) any excess parachute payment (as newly defined by Section 4960(c)(5)) paid by the organization to a "covered employee."

"Remuneration" means "wages," as defined in Section 3401(a), is treated as paid when there is no substantial risk of forfeiture under Section 457(f)(1)(A), and includes amounts required to be included in gross income under Section 457(f), generally (but not Roth contributions). Remuneration for which a deduction under Section 162(m) is not allowed is not included.

A "covered employee" is an employee (including a former employee) if he or she is one of the five highest compensated employees for the tax year, or was a covered employee of the organization (or a predecessor) in any preceding tax year, beginning after December 31, 2016.

"Remuneration" paid to a licensed medical professional (which includes veterinarians) for medical or veterinary services performed by that professional is excluded. But remuneration paid for services other than for the performance of medical or veterinary services is taken into account.

Remuneration includes that paid by a related person or governmental entity ("related party"), if the related party (1) controls or is controlled by the applicable tax-exempt organization; or (2) is a person or governmental entity controlled by one or more persons who control the applicable tax exempt organization; or (3) is a supported or supporting organization (Section 509(f)(3) or Section 509(a)(3)) with respect to the applicable tax-exempt organization during the taxable year; or (4) in the case of a Voluntary Employee Beneficiary Association ("VEBA") (Section 501(c)(9)), establishes, maintains, or makes contributions to the VEBA.

An "excess parachute payment" is determined by calculating the covered person's "base amount," in accordance with rules previously established in a similar (but different) provision that disallows excess parachute payments of taxable corporations (Section 280G(d)). Essentially, the base amount is the employee's annualized includible compensation for the most recent five taxable years. An excess parachute payment is the amount of any parachute payment that exceeds the base amount (more below) allocated to that payment.

A "parachute payment" is a payment (or payments) in the nature of compensation to (or for the benefit of) a covered employee, (1) contingent on the employee's separation from employment; and (2) if the aggregate present value of the payments contingent on the separation exceeds an amount equal to three times the base amount. The term "payments" includes property transfers and contingent payments, utilizing rules under Section 280G(d)(3) and (4). Contingent compensation payments are determined using a discount rate equal to 120 percent of the "Applicable Federal Rate" under Section 1274(d), compounded semiannually.

B. UBTI Increased by Disallowed Fringe Benefit Expenses (§ 512(a)(7)). Tax-exempt organizations will include, as UBTI (taxed at 21 percent), any amount (1) for which a deduction is not allowed under Section 274 (as amended), *and* (2) paid by the organization for any qualified transportation fringe (Sections 132(f), 274(a)(4)), any parking facility used in connection with qualified parking (Section 132(f)(5)(C)), or any on-premises athletic facility (Section 132(j)(4)(B)). Existing provisions (those identified above, in the Section 132 references) that allow employees to treat such expenses as exempt from income tax are unaffected by the change.

"Qualified transportation fringe" benefits under Section 132(f) include transportation in a commuter highway vehicle, if between the employee's residence and place of employment; transit passes; qualified parking; and qualified bicycle commuting reimbursement. Those terms are further delineated in Section 132(f)(5).

As might be expected, the provision does not apply to the extent that the amount is paid or incurred in an unrelated trade or business that is regularly carried on, since it is reasonable to expect that the normal disallowance of such deductions will apply in that situation.

Although tax-exempt organizations in Oregon are not generally subject to the Oregon corporate excise tax, ORS 317.920 makes clear that those that have federal UBTI are. It thus appears that Oregon tax-exempt organizations subject to the new UBTI on disallowed fringe benefits will also be subject to Oregon corporate excise tax on that phantom income. This raises the issue whether foreign tax-exempt organizations that are doing business in Oregon and have UBTI from disallowed fringe benefits will be required to allocate some of the federal UBTI to Oregon and pay Oregon corporate excise tax and, if so, on what basis. (Will allocations be required simply because the entity is doing business in Oregon, or must the disallowed fringe benefits be provided to Oregon employees?) The answer to these questions presents a critical compliance issue, since it is likely that out-of-state exempt organizations that do not have Oregon-sourced UBTI are likely not currently filing an Oregon corporate excise tax return. Current Oregon corporate excise tax rates run around 7 percent.

In the 2018 edition of IRS Publication 15-B, "Employer's Tax Guide to Fringe Benefits," the IRS specifically stated that a workaround that had been proposed by some practitioners will not work. Specifically, some commentators had suggested that a way around the Section 512(a)(7) excise tax would be to increase an employee's compensation by the value of the disallowed fringe benefits (for example, disallowed transportation benefits) and allow the employee to participate in a salary-reduction agreement that would provide the employee with the option of reducing his or her salary by the same amount and using that amount, under the salary reduction agreement, to purchase the transportation benefits directly. The IRS publication states that "no deduction is allowed for qualified transportation benefits (whether provided directly by you, through a bona fide reimbursement arrangement, or through a compensation reduction agreement) incurred or paid after Dec. 31, 2017." IRS Publication 15-B at 21.

Interim guidance provided on the IRS website with respect to reporting the UBTI required under Section 512(a)(7) suggests that, for organizations with fiscal tax years beginning in 2017, the amount should be reported on line 12 of the 2017 form 990-T.

Repeal of Deduction for Certain Lobbying Expenses.

Former subsections 162(e)(2) and (7) have been eliminated and the remaining subsections renumbered accordingly. The subsections used to provide two exceptions to the general rule that lobbying expenses are not tax-deductible. The exceptions permitted deductions for certain lobbying before local legislatures or Indian tribal governments. These changes impact the existing Section 6033(e) obligation of exempt organizations to report such disallowed amounts on their forms 990 and to notify those making payments to such organizations that a portion of their payment is ineligible for income tax deduction. The change is effective for amounts paid or incurred after December 22, 2017.

William Manne is a partner with Miller Nash Graham & Dunn LLP, in Portland, Oregon. He is licensed to practice law in Oregon and Washington, and is a frequent speaker and writer on tax-exempt and charity matters. You can learn more about Mr. Manne, obtain contact information, and access related resources at http://www.millernash.com/william-s-manne/.

Don’t Panic! What You Can Do When Your (Formerly) Nonprofit Client Fails to File Form 990 and Loses Its 501(c)(3) Status

by Valerie H. Sasaki and Rose E. Connolly, both with Samuels Yoelin Kantor LLP, Portland, Oregon

The Internal Revenue Service (“IRS”) will revoke an organization’s § 501(c)(3) tax-exempt status in many situations. Several major areas of concern can lead to loss of tax-exempt status: (1) private inurement; (2) impermissible lobbying or political campaign activity; (3) excessive unrelated business income; (4) operations not in accord with the organization’s stated purpose; and (5) failure to file annual reports (IRS Form 990). Of the areas listed above, the cases involving private inurement are usually the most salacious. However, automatic termination under IRC § 6033(j) for failure to file annual reports is a particularly common cause leading to loss of exemption.

IRC § 6033(a)(1) requires tax-exempt entities to file annual reports that specify the entity’s items of gross income, receipts, and disbursements (among other items). If an entity fails to file such reports for three consecutive years, IRC § 6033(j) authorizes the Secretary of the Treasury to revoke that entity’s tax-exempt status effective on the due date for the third missed return. The IRS will mail the entity a CP120A notice to inform it that its tax-exempt status has been revoked.

As practitioners know, compliance failures happen for a variety of reasons. Sometimes the intentional bad acts of an individual can create a situation where filing annual reports is unlikely or impossible. More commonly though, we see honest but mistaken actions of officers or directors that result in a nonprofit failing to file its annual reports. For example, leadership may incorrectly perceive that because the entity doesn’t pay tax on its receipts, a failure to file is without consequence because the entity doesn’t owe any tax to begin with. Also, organizations with a religious orientation that are not specifically churches may be under the mistaken impression that they are not required to file because churches are generally not required to file Form 990. Finally, if a nonprofit has minimal receipts (less than $50,000), the nonprofit’s leadership may be under the impression that the entity is not required to file an annual report. However, they are still required to file the electronic notice (Form 990-N).

Loss of tax-exempt status is a very big deal. There are consequences beyond the entity merely needing to pay tax on past and future earnings. Donors will not be able to deduct contributions to the entity. Private foundations may not be able to make or continue grant payments to the entity. If there are other tax benefits involved with the particular nonprofit (e.g., parsonage exemptions for certain employees), those can be imperiled. There may also be state-level consequences.

Fortunately, the IRS understands that bad things can happen to good organizations and outlines a path to retroactive reinstatement of an entity’s tax-exempt status in Revenue Procedure 2014-11. It describes three major scenarios:

Streamlined Retroactive Reinstatement for Small Organizations Within 15 Months of Revocation

If your client is a small organization (defined as one that is eligible to file either Form 990-EZ or Form 990-N), the IRS may retroactively reinstate the entity’s exempt status if the entity prepares and files the annual reports that it failed to file (with appropriate caption), prepares and files a new application for tax-exempt status (Form 1023-EZ), and pays the appropriate user fee.

Retroactive Reinstatement of Tax-Exempt Status Within 15 Months of Revocation

Larger entities are not eligible to apply under the streamlined process for retroactive reinstatement. In that case, the entity needs to prepare and file the annual reports it failed to file (with appropriate caption), prepare a new application for tax exemption (Form 1023), write a reasonable cause statement, and submit the application and reasonable cause statement to the IRS with the appropriate user fee. The reasonable cause statement filed within 15 months of revocation only needs to establish reasonable cause for one of the three consecutive years that it failed to file tax returns.

Retroactive Reinstatement of Tax-Exempt Status After 15 Months of Revocation

To obtain retroactive reinstatement of tax-exempt status after 15 months have passed since the entity's tax-exempt status was revoked, the entity must follow the steps addressed above. However, the statement must establish reasonable cause with respect to the entity's failure to file for all three (or more) years that it failed to file annual returns.

Reinstatement from Postmark Date

A nonprofit may also apply for reinstatement from the date it mails the reinstatement application to the IRS. This application does not require that a reasonable cause statement be included, but it does require the appropriate user fee. Our experience is that this process would only be appropriate with an entity that had no operations, donations, or assets during the periods of non-compliance with filing obligations.

What Is Reasonable Cause?

The reasonable cause statement is the critical part of an entity's application for reinstatement. It needs to include a detailed explanation of the events leading to the nonprofit's failure to file, the discovery of the failure, and the steps that will be taken to mitigate and prevent future failures. This is combined with a summary of applicable law and relevant IRS policies, and the analysis concluding that the entity had reasonable cause leading to its failure to file.

Revenue Procedure 2014-11 cites several facts that can weigh in favor of finding reasonable cause. These include good-faith reliance on erroneous written information from the IRS, events beyond the organization's control, and quick action to rectify the failure and implementation of steps to correct the failure in the future. An established history of compliance with filing obligations is, of course, a strong factor weighing in favor of an entity's reasonable cause statement. The IRS requires an officer, or other fiduciary authorized to sign on behalf of the entity, to sign a declaration under penalties of perjury that the facts set forth in the application for retroactive reinstatement are correct.

Don't Panic

The single most important thing that you can tell your clients when they receive that scary IRS notice revoking their tax-exempt status (or find it in a drawer after someone who was supposed to file Form 990 has left the organization) is "DON'T PANIC." As discussed above, many situations are fixable if the entity is willing to take the steps necessary to address the problem and implement processes to ensure future compliance with reporting obligations.

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NOLS Publications Committee:
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