2024 National Income Tax Workbook

CHAPTER 5: BUSINESS ENTITY TAX ISSUES

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Chapter Issues P. 145

- Pass-Through Entity Tax
- Beneficial Ownership Interest Reporting
- I.R.C. §501(c)(3) Charitable Organizations, Maintaining Tax-Exempt Status
- Change in Tax-Exempt Status
- Electing Out of the Centralized Partnership Audit Regime

Learning Objectives

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- Understand the federal tax treatment of pass-through entity payments of state and local tax
- Know when a refund of pass-through entity credits may be included in income under the tax benefit rule
- Understand the FinCEN beneficial ownership interest reporting requirements
- Recognize the actions that can jeopardize the tax-exempt status of an I.R.C. 501(c)(3) organization
- Explain how an I.R.C. §501(c)(3) organization can change its tax-exempt status to a different §501(c) organization
- Understand what partnerships are eligible to elect out of the centralized partnership audit regime
- Know the advantages and disadvantages of electing out of the centralized partnership audit regime

Introduction P. 146

- State laws allow pass-through entities to pay state & local taxes at the entity level
  - Deduction is taken at the federal level with corresponding benefit or offset at the owner-level
  - Refund may be included in income under I.R.C. §111, tax benefit rule
- Corporate Transparency Act (CTA) to prevent & combat money laundering, terrorist financing, corruption, tax fraud, and other illicit activity
  - Filing requirements
  - Beneficial owners
- Tax-exempt organization noncompliance and loss of exempt status
- New revenue procedure allows an exempt organization to change its designation
- Electing out of the centralized partnership audit regime

Issue 1

PASS-THROUGH ENTITY TAX

Pass-Through Entity Tax P. 147

- TCJA limited deduction for state & local taxes
- $10,000, MFS ($5,000)
- State & local taxes (SALT) include:
  - Personal property tax
  - Income tax
  - War profits and excess profits
  - General sales tax
- I.R.C. §164(b)(6) – taxes imposed at the entity level, that are reflected on Schedule K-1 (or similar) reduce the recipient's distributive or pro rata share of income
- 36 states have passed a SALT work around

State Pass-Through Entity Tax (PTET) P. 147

- Partnership or S corp pays the tax & deducts it
- Partners or owners receive a credit/offset against their state tax liability

- Notice 2020-75, 2020-49, I.R.B. 1453
  - SALT imposed on and paid by the PTE is not subject to SALT limitations
  - Specified income tax payment (SITP) –any amount paid by a partnership or an S corporation to a state, a political subdivision of a state, or the District of Columbia (a domestic jurisdiction), to satisfy its income tax liability imposed by the domestic jurisdiction on the partnership or the S corporation

Notice 2020-75 PP. 147-148

- If a PTE makes an SITP during a tax year, the PTE can deduct the SITP when computing its taxable income for the tax year in which the payment is made
- Partners and S corporation shareholders receive a federal deduction for these entity-level payments, resulting in a benefit that is like what was provided to PTE owners before the SALT limitation was enacted
- Definition of an SITP includes only income taxes

Notice 2020-75 PP. 147-148

- Does not differentiate between the character of the income (i.e., capital or ordinary) giving rise to the SITP
- Does not specify that the payment must be for trade or business activities vs. investment
- Not a separately stated item
- Example 5.1 – Deduction of PTET Payment
- Any SITP made by a PTE does not count in applying the SALT deduction limitation
- Example 5.2 – PTET Payment Does Not Reduce Itemized Deductions

Example 5.1

Deduction of PTET Payment

Leanne Lotan (unmarried) is the sole shareholder in an S corporation. Under state law, the S corporation can elect to pay state income tax on its business income. In 2024, the S corporation had \$325,000 business income, and Leanne would have a \$21,938 (\$325,000 × 6.75%) state income tax liability. Leanne caused the S corporation to pay \$21,000 PTET in 2024. The S corporation reports \$304,000 (\$325,000 – \$21,000) business income to Leanne on Schedule K-1 (Form 1120-S), Shareholder's Share of Income, Deductions, Credits, etc. Leanne reports that income on her Form 1040, U.S. Individual Income Tax Return, and claims the standard deduction. Leanne receives a \$21,000 state credit that offsets her state income tax liability. Thus, Leanne has a \$21,000 federal deduction for state income taxes instead of the maximum \$10,000 deduction that she could have claimed on Schedule A (Form 1040), Itemized Deductions.

Example 5.2

PTET Payment Does Not Reduce Itemized Deductions

The facts are the same as in Example 5.1 except that Leanne itemizes deductions on her 2024 return. If Leanne paid $14,000 in state property tax in 2024, she could claim a $10,000 itemized deduction for the property tax paid. The entity-level PTET payment does not reduce Leanne's SALT deduction limit.

Practitioner Note P. 148

- Notice 2020-75 was issued in November 2020, but the proposed regulations have not yet been published
- The (AICPA) has identified several federal tax issues on which additional guidance is needed

Tax Benefit Rule P. 149

- I.R.C. §111 – refundable PTE tax credits may be includable in income tax
- Requires the taxpayer to include recovered losses, credits, or deductions only if the amounts claimed in a prior year provided a tax benefit
- An item gives rise to a *tax benefit* in the tax year the item is originally included on a tax return if it reduces the tax liability for that or any other year
- Itemized deductions give rise to a tax benefit because they reduce tax liability
- A net operating loss (NOL) that can be carried over creates a tax benefit in the original tax year of the NOL
- The tax benefit rule determines when recovered amounts are included in income, and when those amounts are excluded from income by the recovery exclusion

Tax Benefit Rule P. 149

- I.R.C. §111(b)(3) does not apply to
  - Investment tax credit
  - Foreign tax credit
- Example 5.3 – State Tax Refund Included in Income
  - Figure 5.1 – Portion of Refund Included in Cheyenne's Income

Example 5.3

State Tax Refund Included in Income

In 2024, Cheyenne Eubank's adjusted gross income (AGI) was $250,000. She deducted $9,000 of state income taxes and $7,000 of mortgage interest on Schedule A (Form 1040). Her total itemized deductions were $16,000, and the 2024 standard deduction for a single taxpayer was $14,600. In 2025, Cheyenne received a $2,000 state income tax refund for the 2024 tax year. The refund was a recovery of a tax benefit item. Cheyenne must include $1,400 of the refund in her 2025 income, which is calculated in **Figure 5.1**.

Figure 5.1

Portion of Refund Included in Cheyenne's Income

Tax Item	2024 Itemized Deduction	2024 Standard Deduction	Difference
Adjusted gross income	$250,000	$250,000	$ 0
Itemized or standard deduction	(16,000)	(14,600)	1,400
Taxable income	$234,000	$235,400	$1,400

Example 5.4

Example 5.4
State Tax Refund Not Included in Income

The facts are the same as in Example 5.3, except that Cheyenne paid $12,000 in state and local taxes and claimed a $10,000 deduction (after application of the SALT limitation). If Cheyenne receives a $2,000 state income tax refund, it does not reduce her 2024 deduction. She received no tax benefit and the $2,000 refund is not included in her income.

Tax Benefit Rule PP. 149-150

- Example 5.4 – State Tax Refund Not Included in Income
- Cross-Reference – Recovery Exclusion
  - Tax benefit items in a tax year are considered as a group
  - A group of tax benefit items for one year must be kept separate from a group of tax benefit items for another year
  - A recovery exclusion is any amount in the group of tax benefit items that did not create a tax benefit

- *Maines v. Commissioner*, 144 T.C. 123 (2015)
  - Whether refundable state tax credits were included in federal income
  - Married New York residents who received a credit for state property taxes
  - Credit was limited to actual property taxes paid by their partnership
  - Court found the credit to be like a refund of overpaid property taxes
  - Held that the property tax credit that reduced the taxpayers' state tax liability was not a taxable accession to wealth.
  - The refundable portion of the property tax credit was subject to the tax benefit rule and was included in income to the extent that the taxpayers received a corresponding tax benefit for prior-year property tax deductions

Tax Benefit Rule P. 150

- Example 5.5 – Refundable Credit Included in Income
- Figure 5.2 $8,400 refund included in income

Example 5.5

Refundable Credit Included in Income

Sylvia Chen is a partner in S&B partnership. In 2024, the partnership allocated $300,000 of ordinary income to Sylvia, which was her $330,000 share of ordinary income reduced by her $30,000 allocable share of an SITP. This partnership allocation was her only source of income. Sylvia claimed the standard deduction and her federal taxable income was $285,400 ($300,000 – $14,600). Sylvia's state provides a refundable credit for the SITP payment. Her state taxable income is shown in **Figure 5.2**.

Figure 5.2

Sylvia's State Taxable income

Item	Amount
Federal adjusted gross income	$300,000
SITP	30,000
State standard deduction	(10,000)
State taxable income	$320,000
State tax rate	× 6.75%
State tax liability	$ 21,600
SITP credit	(30,000)
State tax refund	$ 8,400

Ordering Rules P. 151

- A state income tax refund from an SITP may be excludable from federal taxable income
  - If the taxpayer's estimated and withholding tax payments were applied last; and
  - The taxpayer claimed the federal standard deduction
  - A portion or none of the state income tax refund may have to be included in federal taxable income.
- Example 5.6 – Ordering of Estimated Tax Payment
  - Figure 5.3 – estimated tax payments applied before SITP
  - Figure 5.4 – estimated tax payments applied after SITP

Example 5.6

Ordering of Estimated Tax Payment

The facts are the same as in Example 5.5 except that Sylvia made $10,000 in state estimated tax payments and claimed the federal standard deduction. **Figure 5.3** shows the result if the estimated tax payments are applied before the SITP, and Figure 5.4 shows the result if the estimated tax payments are applied after the SITP.

Figure 5.3

Sylvia's State Taxable Income with Estimated Tax Payment Applied First

Item	Amount
Federal adjusted gross income	$300,000
SITP	30,000
State standard deduction	(10,000)
State taxable income	$320,000
State tax rate	× 6.75%
State tax due (6.75%)	$ 21,600
Estimated tax payments	10,000
SITP credit	(30,000)
State tax refund	$18,400

Figure 5.4

Sylvia's State Taxable Income with Estimated Tax Payment Applied Last

Item	Amount
Federal adjusted gross income	$300,000
SITP	30,000
State standard deduction	(10,000)
State taxable income	$320,000
State tax rate	× 6.75%
State tax due	$ 21,600
SITP credit	(30,000)
Estimated tax payments	10,000
State tax refund	$18,400

Issue 2

BENEFICIAL OWNERSHIP INTEREST REPORTING

Corporate Transparency Act P. 152

- In September 2022, FinCEN) issued a final rule implementing the beneficial ownership information reporting requirements of the Corporate Transparency Act
- These requirements are intended to help prevent and combat money laundering, terrorist financing, corruption, tax fraud, and other illicit activity, while minimizing the burden on entities doing business in the United States
- These regulations went into effect on January 1, 2024
- The final rule requires certain entities to file FinCEN reports that identify two categories of individuals:

  (1) the beneficial owners of the entity and

  (2) individuals who have filed an application with specified governmental authorities to create the entity or register it to do business

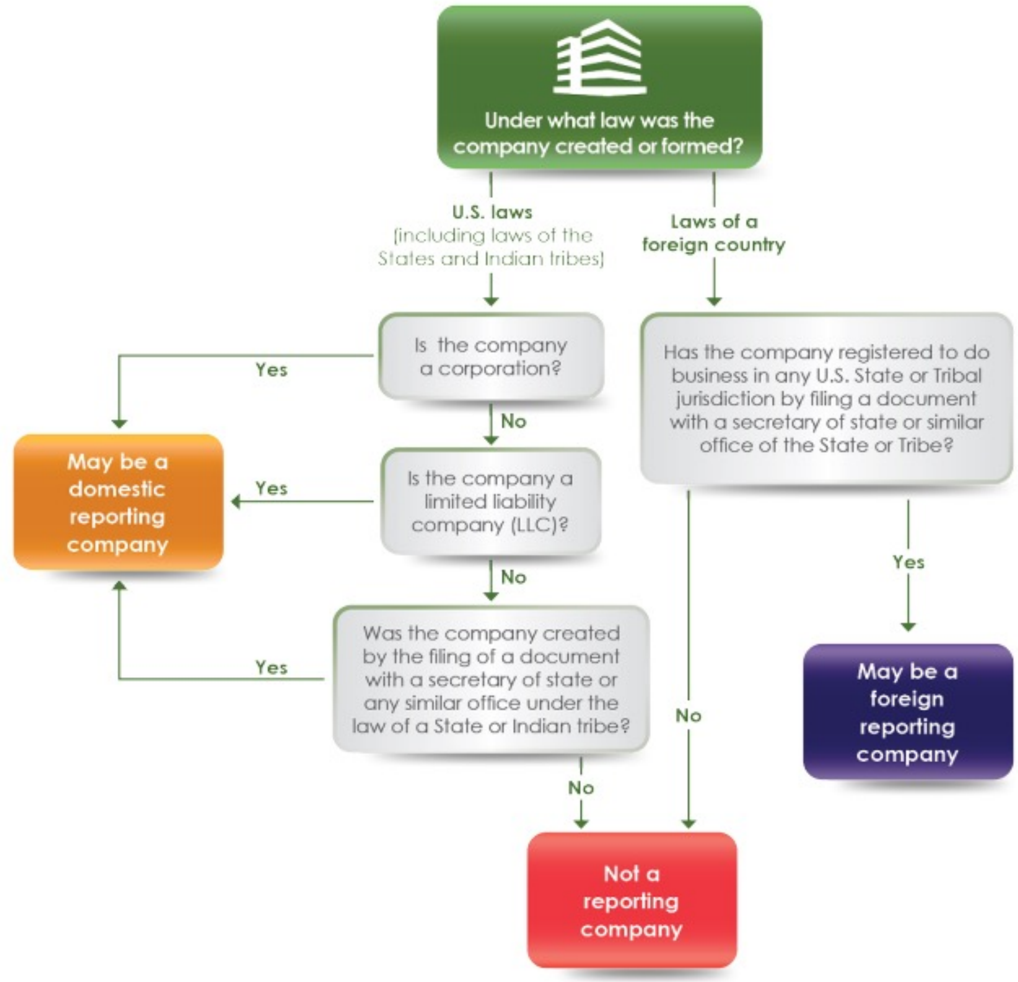
Corporate Transparency Act P. 152

- Cross-Reference – Unauthorized Practice of Law
  - Beneficial ownership reporting may constitute the unauthorized practice of law if it involves interpreting laws and giving advice regarding a client’s rights and obligations under those laws
  - See the “Ethics” chapter in this book for information about how a tax practitioner can comply with his or her ethical duties to not engage in the practice of law, to protect confidential client information, and the duty of competence when assisting with CTA reporting

Reporting Companies P. 152

- Two types of reporting companies
  - A domestic reporting company is a corporation, LLC, or any entity created by filing a document with a secretary of state or any similar office under the law of a state or Indian tribe
  - A foreign reporting company is a corporation, LLC, or other entity formed under the law of a foreign country that is registered to do business in any state or tribal jurisdiction by filing a document with a secretary of state or any similar office
- Reporting companies will include (subject to the applicability of specific exemptions) LLPs, LLLP, business trusts, and most limited partnerships, in addition to corporations and LLCs
- Other types of legal entities, including sole proprietorships, certain trusts, and general partnerships are excluded from the definitions to the extent that they are not created by filing a document with a secretary of state or similar office

Figure 5.5 – Determining if an Entity is a Reporting Company
P. 153



23 Exempt Entities

List of 23 exempt entities

Note – read the full exemption for additional details

Practitioner Note P. 155

Sole Proprietorship

- It is not a reporting company unless file with sec. of state
- Filing a document with a government agency to obtain an EIN, fictitious business name, or a professional or occupational license does not make a sole proprietorship a reporting company

Beneficial Owners

P. 155

A beneficial owner includes any individual who directly or indirectly, who either

- exercises substantial control over a reporting company; or
- owns or controls at least 25% of the ownership interests of a reporting company.

- The following five types of individuals are exempt from the *beneficial owner* definition:

1. A minor child, as defined under the law of the state or Indian tribe in which a domestic reporting company is created or a foreign reporting company is first registered, provided that the reporting company reports the required information of a parent or legal guardian of the minor child
2. An individual acting as a nominee, intermediary, custodian, or agent on behalf of another individual
3. An employee of a reporting company, acting solely as an employee, whose substantial control over or economic benefits from such entity are derived solely from the employment status of the employee, provided that such person is not a senior officer
4. An individual whose only interest in a reporting company is a future interest through a right of inheritance
5. A creditor of a reporting company

Substantial Control P. 155

An individual exercises substantial control over a reporting company if

the individual serves as a senior officer of the reporting company, the company's president, chief financial officer, general counsel, chief executive office, chief operating officer, or any other officer who performs a similar function;

has authority over the appointment or removal of any senior officer or a majority of the board of directors (or similar body);

directs, determines, or has substantial influence over important decisions made by the reporting company; or

has any other form of substantial control over the reporting company.

Ownership Interests P. 156

- Arrangement that establishes ownership rights in the reporting company
- Examples: shares of equity, stock, voting rights, or any other mechanism used to establish ownership
- If an entity is organized as something other than a corporation but makes the S election for federal income tax purposes, the individual's ownership interest is calculated as a percentage of the total shares of stock issued
- If some shares of stock have more voting power or represent more of the value of the company then other shares, the calculation of ownership must include the additional control
  - Example: A shares have 1 vote and B shares has 10 votes

Company Applicants

The individual who directly files the document that creates the entity, or for a foreign reporting company, the document that first registers the entity to do business in the United States

The individual who is primarily responsible for directing or controlling the filing of the relevant document by another

Report starting January 1, 2024

Beneficial Ownership Information Reports PP. 156-157

Required Company Information

- Legal name
- Any trade names, doing business as (d.b.a.), or trading as names

The current street address of its principal place of business if that address is in the United States (for example, a US reporting company's headquarters), or, for reporting companies whose principal place of business is outside the United States, the current address from which the company conducts business in the United States (for example, a foreign reporting company's US headquarters)

- Its jurisdiction of formation or registration
- Its taxpayer identification number (TIN) or, if a foreign reporting company has not been issued a TIN, a TIN issued by a foreign jurisdiction and the name of the jurisdiction

- Initial report, correction, or update

Beneficial Owner Information P. 157

Required for all beneficial owners

- The individual’s name
- The individual’s date of birth
- The individual’s residential address
- An identifying number from an acceptable identification document such as the individual’s passport or US driver’s license, and the name of the issuing state or jurisdiction of the identification document
- An image of the identification document

Company Applicant Information P. 157

- For each company applicant, a reporting company will have to provide the following:
  - The individual’s name
  - The individual’s date of birth
  - The individual’s address (If the company applicant works in corporate formation—for example, as an attorney or corporate formation agent—then the reporting company must report the company applicant’s business address. Otherwise, the reporting company must report the company applicant’s residential address)
  - An identifying number from an acceptable identification document such as the individual’s passport or US driver’s license, and the name of the issuing state or jurisdiction of the identification document
  - An image of the identification document

Identification P. 157

For both the beneficial owner and the company applicant, the following are acceptable forms of identification:

- A nonexpired US driver's license (including any driver's licenses issued by a common-wealth, territory, or possession of the United States)
- A nonexpired identification document issued by a US state or local government, or Indican tribe
- A nonexpired passport issued by the US government
- A nonexpired passport issued by a foreign government (only when an individual does not have one of the other forms of identification listed above
- Practitioner Note – Street Address Required

FinCEN Identifier P. 157

A FinCEN identifier is a unique identifying number that FinCEN will issue to individuals who have provided FinCEN with their beneficial ownership information (BOI) (Individual FinCEN identifiers) or given to reporting companies that have filed initial BOI reports (entity FinCEN identifiers)

- Once a beneficial owner or company applicant has obtained a FinCEN identifier, the reporting entity may report the identifier in place of the otherwise required personal information in their BOI reports

Report Timing P. 158

- Reporting companies created or registered before January 1, 2024 will have 1 year (until January 1, 2025) to file their initial reports
- Reporting companies created or registered on or after January 1, 2024, must file a report within 30 calendar days of the earlier of
  - the date that it receives actual notice that it has been registered to do business; or
  - the date that a secretary of state or similar office first provides public notice, such as through a publicly accessible registry, that the foreign reporting company has been registered to do business
- FinCEN extended the initial BOI reporting deadline from 30 to 90 days for reporting companies created or registered in 2024. Reporting companies formed on or after January 1, 2025, must submit their initial BOI reports within 30 days
- Reporting companies have 30 days to report changes or corrections

Updated Report PP. 158-159

- Update or report changes within 30 days
  - The following are some examples of the changes that would require an updated beneficial ownership information report:
    - A change to the information reported for the reporting company, such as registering a new business name
    - A change in beneficial owners, such as a new CEO, or a sale that changes who meets the 25% ownership interest threshold
    - A change to a beneficial owner's name, address, or unique identifying number previously provided to FinCEN

Enforcement P. 159

Penalties

- Correct mistakes or omissions within 90 days of the deadline for the original report
- Civil & criminal penalties for willful failure
- $500 civil penalties
- $10,000 criminal penalties and up to 2 years imprisonment
- Responsibility of the reporting company
- Both individuals and corporate entities can be held liable
- Practitioner Note – Ongoing Compliance

Issue 3

§501(C)(3) CHARITABLE ORGANIZATIONS & MAINTAINING TAX-EXEMPT STATUS

501(c)(3) Organizations P. 160

- Organizations described in section 501(c)(3), other than testing for public safety organizations, are eligible to receive tax-deductible contributions under I.R.C. § 170
- Ongoing compliance issues that may result in denial or revocation of tax-exempt status, or a change in that status:
  - Failing the organizational or operational test by, for example, engaging in more than insubstantial nonexempt activities or deviating from the exempt purpose reported on the application for tax-exempt status
  - Filing Form 1023-EZ when the charitable organization is ineligible to file the short form
  - Failing to maintain public charity status by not generating public support from grants and donations
  - Earning too much income from unrelated business activities
  - Not complying with annual notice or return filing requirements

Failing the Organizational or Operational Test

- If a charitable organization is not organized and operated for an exempt purpose, it is initially ineligible for tax-exempt status or it may lose that eligibility
- To be exempt as a section 501(c)(3) organization, an entity must be both organized and operated exclusively for one or more purposes specified in that section
- None of the organization's earnings may inure to any private shareholder or individual
- It may not be an action organization (i.e., it may not attempt to influence legislation as a substantial part of its activities, and it may not participate in any campaign activity for or against political candidates)

Exempt Purposes P. 160

The exempt purposes set forth in section 501(c)(3) are charitable, religious, educational, scientific, literary, testing for public safety, fostering national or international amateur sports competition, and preventing cruelty to children or animals

- Charitable purpose is viewed by the IRS and the courts in its most expansive meaning, and includes, for example, relief of the poor and distressed such as assistance to low-income families, self-help programs, and assisting the aged, ill, or disabled. It includes fire, rescue, and emergency services and can include promotion of the arts and sciences
- Maintaining public parks, public monuments, other kinds of public works, and providing recreational facilities for the entire community furthers charitable purposes.
- Organizations engaged in the development, conservation, and protection of natural resources for the benefit of the entire community

Exempt Purposes (cont.) PP. 160-161

- Lessening the burdens of government
- The organization must demonstrate its activities serve a public rather than a private interest
- Examples – lessening neighborhood tensions, eliminating prejudice & discrimination, defending human & civil rights secured by law, or combatting community deterioration & juvenile delinquency
- Religious Organizations – the religious beliefs of the organization must be truly and sincerely held. The practices and rituals associated with the organization's religious belief or creed cannot be illegal or contrary to clearly defined public policy
- Example 5.7 – Insubstantial Religious Purposes
- Educational Organizations - the instruction or training of the individual for the purpose of improving or developing his or her capabilities, or the instruction of the public on subjects useful to the individual and beneficial to the community. This advancement of education may include grants, scholarships, and awards; promotion of the arts, humanities, and science; job training; publishing scientific journals; and advocacy

Organizational Test P. 161

- Organized exclusively for a charitable purpose
- The organization must be a corporation (or unincorporated association), a community chest, a fund, or a foundation
- A charitable trust is a fund or foundation and will qualify. However, an individual will not qualify. The organization’s purpose and assets must be dedicated to an exempt purpose
- Cross-Reference – Exempt LLCs

PP. 161-162

Dedication of Organization's Purpose

- The organizing documents (i.e., the articles of incorporation and bylaws for a corporation) must
  - limit the organization's purposes to exempt purposes in section 501(c)(3); and
  - must not expressly empower it to engage, other than as an insubstantial part of its activities, in activities that are not in furtherance of one or more of those purposes
  - This requirement may be met if the purposes stated in the organizing documents are limited by reference to section 501(c)(3)
- The organizational documents should prohibit inurement of earnings to private shareholders or individuals, prohibit political activity, and limit legislative activity

Dedication of Organization's Purpose P. 162

An organization is not considered to be organized exclusively for one or more exempt purposes if, by the terms of its articles, the purposes for which the organization is created are broader than the specified charitable purposes

- The fact that the actual operations of such an organization have been exclusively in furtherance of one or more exempt purposes is not sufficient to allow the organization to meet the organizational test
- Similarly, such an organization does not meet the organizational test through statements or other evidence that the members intend to operate only in furtherance of one or more exempt purposes
- Example 5.8 – Broad Purposes
- Example 5.9 – Vague Purposes

An organization does not meet the organizational test if its articles or the law of the state in which it was created provide that its assets will, upon dissolution, be distributed to its members or shareholders

Dedication of Organization’s Assets PP. 162-163

- To meet the organizational test, an organization’s assets must be permanently dedicated to an exempt purpose
- This means that if an organization dissolves, its assets must be distributed for an exempt purpose, to the federal government, or to a state or local government for a public purpose
- To establish that an organization’s assets will be permanently dedicated to an exempt purpose, its organizing documents should contain a provision ensuring their distribution for an exempt purpose in the event of dissolution
- If a specific organization is designated to receive the organization’s assets upon dissolution, the organizing document must state that the named organization must be a section 501(c)(3) organization when the assets are distributed

Dedication of Organization’s Assets P. 163

- Treas. Reg. 1.501(c)(3)-1(b)(4) - An organization does not meet the organizational test if its articles or the law of the state in which it was created provide that its assets will, upon dissolution, be distributed to its members or shareholders
- Example 5.10 – Assets Not Dedicated to Exempt Purpose
- Practitioner Note – Amending Articles

Operational Test PP. 163-164

Treas. Reg. 1.501(c)(3)-1(c) – operational test 3 requirements

1. *Primary activities*. The organization engages primarily in activities that accomplish one or more of the exempt purposes specified in section 501(c)(3)
2. *Distribution of earnings*. The organization's net earnings do not inure in whole or in part to the benefit of private shareholders or individuals
3. *Action organizations*. The organization is not operated exclusively for one or more exempt purposes if a substantial part of its activities is attempting to influence legislation by propaganda or if it participates or intervenes, directly or indirectly, in any political campaign on behalf of or in opposition to any candidate for public office

Organizational or Operational Changes P. 164

- An exempt organization must report name, address, and structural changes to the IRS
- For example, the organization materially changes its activities from those described in its exemption application, it must notify the IRS of that change. Failure to notify the IRS could result in loss of the entity's tax-exempt status
- If an organization files an annual return (such as a Form 990 or 990-EZ), it must report the changes on its return. An organization that is not required to file Form 990 or Form 990-EZ may report the changes to the Exempt Organizations Determinations office

Form 1023-EZ Ineligibility P. 164

- Except for churches, their integrated auxiliaries, conventions or associations of churches, and public charities whose annual gross receipts are normally less than $5,000, organizations are not treated as described in section 501(c)(3) unless they notify the IRS by applying for recognition of section 501(c)(3) status
- Under I.R.C. § 508(a) an organization [except for organizations specified in I.R.C. § 508(c)] must provide notice to the IRS that it is applying for recognition of Section 501(c)(3) exempt status
- Treas. Reg. § 1.508-1(a)(2)(i) states that the notice is given by submitting a properly completed and executed exemption application on Form 1023, Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code; or
- Under certain circumstances, Form 1023-EZ, Streamlined Application for Recognition of Exemption §501(c)(3) of the Internal Revenue Code

Form 1023 Application P. 164

- Form 1023 is divided into eleven parts.
- Requests detailed information on the organization's structure, governance, activities, income streams, expenditures, history, and other specific questions depending on the organization's foundation status under I.R.C. §§ 509(a) and 170(b) (1)(A).

Form 1023-EZ Application P. 165

- Form 1023-EZ -- Small organizations with annual gross receipts of $50,000 or less and $250,000 or less in assets
  - Eligibility worksheet [www.irs. gov/instructions/i1023ez]
  - If all the questions are answered in the negative, the organization is eligible to complete the short form
- A misstatement of material information includes an incorrect attestation as to the organization’s organizational documents, the organization’s exempt purposes, the organization’s conduct of prohibited and restricted activities, or the organization’s eligibility to file Form 1023-EZ
- Example 5.11 – Ineligible to File Form 1023-EZ

Maintaining Public Charity Status P. 165

- Public Charity – broad sources of support
- Private Foundation – very limited sources of support
- I.R.C. §508(b) – every organization is automatically classified as a private foundation unless it meets one of the exemptions in I.R.C. §508(c) or §509(a)

Maintaining Public Charity Status P. 165

Some of the organizations that are statutorily classified as public charities:

- Churches
- Schools
- Organizations that provide medical or hospital care (including the provision of medical education and in certain cases, medical research)
- Organizations that receive a substantial part of their support in the form of contributions from publicly supported organizations, governmental units, and/or from the general public
- Organizations that normally receive not more than one-third of their support from gross investment income and more than one-third of their support from contributions, membership fees, and gross receipts from activities related to their exempt functions
- Organizations that support other public charities

Public Support Tests P. 166

Two public support tests

- The 509(a)(1) test (item 4 in the previous list) requires that the organization receive at least one-third of its support from contributions from the general public; or meet a 10% percent facts and circumstances test.
- Practitioner Note – Two-percent Limit
- The 509(a)(2) test (item 5 in the previous list) requires that the organization receive more than one-third of its support from contributions from the general public and/or from gross receipts from activities related to its tax-exempt purposes

Ongoing Public Support P. 166

Public support is measured using a 5-year computation period that includes the current and 4 prior tax years (including short years)

- If the organization requests public charity classification based on receiving support from the public, it must continue to seek significant and diversified public support in later years
- If the organization does not meet the public support requirement, it could be reclassified as a private foundation

- Example 5.12 – Significant Public Support

PP. 166-167

Unrelated Business Taxable Income

- An exempt organization is not taxed on its income from an activity that is substantially related to its exempt purpose, even if the activity is a trade or business
- An exempt organization that regularly carries on one or more trades or businesses that are not substantially related to the organization's exempt purpose will generally be subject to tax on its income from the unrelated trade or business
- Earning too much income from unrelated business activities can jeopardize an organization's 501(c)(3) tax-exempt status
- If the organization operates a regularly carried-on trade or business that is not substantially related to the organization's exempt purpose, it may not meet the operational test under section 501(c)(3) (requirement to operate for a substantial exempt purpose)

Unrelated Trade or Business P. 167

- Use of the profits from an unrelated business in furtherance of an organization's exempt purpose does not, by itself, make the activity substantially related to the performance by the organization of its exempt purpose or function
- A *trade or business* generally refers to any activity conducted with the intent to produce income from selling goods or performing services
  - An activity can be a trade or business even though it is conducted within a larger group of similar activities that may be related to the exempt purposes of the organization
  - For example, soliciting, selling, and publishing commercial advertising is a trade or business even though the advertising is published in an exempt organization's periodical that contains editorial matter related to the organization's exempt purpose

Unrelated Trade or Business P. 167

Regularly conducted - if frequency and continuity and are pursued in a manner like comparable commercial activities of nonexempt organizations

- Example 5.13 – Not a Regularly Conducted Activity

Substantially related – if it contributes importantly to accomplishing that purpose

- Facts & Circumstances – size & extent of the activities in relation to the nature & extent of the exempt function
- Gross income derived from exempt function & unrelated trade/business are not the same

Unrelated Trade or Business P. 168

- Example 5.14 – Multiple Uses Activity
- Selling products that result from the performance of exempt functions is generally not an unrelated trade or business if the product is sold in substantially the same form it is in when the exempt functions are completed. It is unrelated trade or business if a completed product resulting from an exempt function is used in further business activity beyond what is reasonably necessary to dispose of the product

Excluded trade or business activities

  - Any trade or business in which substantially all the work in carrying on such trade or business is performed for the organization without compensation
  - Any trade or business carried on primarily for the convenience of its members, students, patients, officers, or employees
  - Any trade or business that consists of selling merchandise, substantially all of which the organization received as gifts or contributions
- Other excluded activities – gaming, convention or trade shows, distributions of low-cost articles, & qualified sponsorship activities

Filing Form 990 Series PP. 168-169

- Practitioner Note – UBTI Filing Requirements
  - Form 990-T
- Exempt Organization filing requirements –I.R.C §6033
  - Form 990 Series
  - Due 15th day of 5th month following close of calendar or fiscal year
  - If fail to file a return for 3 consecutive years – tax-exempt status is automatically revoked
  - §6033(a)(3), churches, religious orders, and certain other organization (other than a private foundation) with gross receipts in each tax year normally not more than $5,000 do not have to file an annual return

Filing Requirements P. 169

- Form 990-N. Normally have gross receipts of $50,000 or less. Form 990-N (e-Postcard) is a notice, not a return

- Form 990-EZ. Gross receipts that are less than $200,000 and total assets at the end of the tax year that are less than $500,000

- Form 990. Gross receipts greater than or equal to $200,000, or total assets greater than or equal to $500,000 at the end of the tax year

Revocation of Exempt Status

- Failure to file a required Form 990 series notice or return for 3 consecutive years will result in automatic revocation of tax-exempt status on and after the due date for filing its third annual return or notice
- The organization must then apply to reinstate tax-exempt status
- Under I.R.C. § 6033(j)(1), if a tax-exempt organization fails to file its required annual return or notice for 2 consecutive years, the IRS must notify the organization
  - That the IRS has no record of such a return or notice from the organization for 2 consecutive years, and
  - The IRS will revoke the organization's tax-exempt status if it fails to file the return or notice by the due date for the next return or notice required to be filed

Reinstatement of Exempt Status P. 169

Four reinstatement procedures

1. Streamlined Retroactive
2. Retroactive within 15 months
3. Retroactive after 15 months
4. Postmark date

Streamlined Retroactive Reinstatement

- Organizations that were eligible to file Form 990- EZ or 990-N for the 3 years that caused their revocation may have their tax-exempt status retroactively reinstated to the date of revocation if they have not previously had their tax-exempt status automatically revoked
- They must complete and submit Form 1023 or Form 1023-EZ, with the appropriate user fee, no later than 15 months after the later of the date of the organization's Revocation Letter (CP-120A) or the date the organization appeared on the revocation list on the IRS website

Retroactive Reinstatement within 15 months

Organizations that cannot use the streamlined retroactive reinstatement process (such as those that were required to file Form 990 or Form 990- PF for any of the 3 years that caused revocation or those that were previously auto-revoked) may have their tax-exempt status retroactively reinstated to the date of revocation if they do the following:

- Complete and submit Form 1023 with the appropriate user fee not later than 15 months after the later of the date on the organization's revocation letter (CP-120A) or the date the organization appeared on the revocation list on the IRS website
- Include with the application a statement establishing that the organization had reasonable cause for its failure to file a required annual return for at least 1 of the 3 consecutive years in which it failed to file
- Include with the application a statement confirming that it has filed required returns for those 3 years and for any other tax years after such period and before the postmark date of the application for which required returns were due and not filed
- File properly completed and executed paper annual returns for the 3 consecutive years that caused the revocation and any following years. The organization should write "Retroactive Reinstatement" on these returns

Retroactive Reinstatement after 15 months

- Organizations that apply for reinstatement more than 15 months after the later of the date on the organization's revocation letter (CP-120A) or the date the organization appeared on the revocation list on the IRS website may have their tax-exempt status retroactively reinstated to the date of revocation if they satisfy all the requirements for retroactive reinstatement within 15 months; and
- The reasonable cause statement the organization includes with its application establishes reason able cause for its failure to file a required annual return for all 3 consecutive years in which it failed to file

Postmark Date Reinstatement

Organizations may apply for reinstatement effective from the postmark date of their application if they complete and submit Form 1023 or Form 1023-EZ with the appropriate user fee

Subsequent Automatic Revocations

- An organization whose tax-exempt status has been automatically revoked and reinstated may have its tax-exempt status automatically revoked again
- Fails to file required annual returns or notices for another 3 consecutive tax year period beginning with the tax year in which the IRS approves its application for reinstatement of tax-exempt status
- Rev. Proc. 2014-11 – reinstatement of its tax-exempt status after a subsequent revocation

Issue 4

CHANGE IN TAX-EXEMPT STATUS

Rev. Proc. 2024-5 P. 172

- Allows for change in exempt status
- Currently recognized under §501(c)(3)
- Organization must request status change

When to Request a Determination Letter

- Rev. Proc. 2024-5 §3.01(1)
  - has distributed its assets to another section 501(c)(3) organization or government entity, and
  - otherwise meets the requirements for the section 501(c) status requested

Rev. Proc. 2024-5 also applies to a section 501(c)(3) that seeks retroactive reinstatement under a different paragraph of section 501(c)

- Example 5.15 – Change from §501(c)(3) to §501(c)(4)

Format of Request

- An organization currently recognized as described in section 501(c)(3) that seeks recognition as described in a different paragraph of section 501(c) must represent;
  - that its assets have been distributed as of the submission date of its application; and
  - provide a description of the assets distributed, the date of distribution and the name, employer identification number, and address of the recipient and agree to submission (postmark) date for recognition under the new paragraph of section 501(c)
- The required representation may be included with the organization's supplemental responses in the single PDF file submitted with its Form 1024, Application for Recognition of Exemption Under Section 501(a) or Section 521 of the Internal Revenue Code; or with its Form 1024-A, Application for Recognition of Exemption Under Section 501(c)(4) of the Internal Revenue Code

Form 1024 & 1024-A Application P. 173

- An organization seeking a determination letter from the IRS recognizing tax-exempt status under I.R.C. §501(c)(2), (5)–(19), (21)–(23), (25)–(29), or (d) must electronically submit a completed Form 1024, Application for Recognition of Exemption Under Section 501(a) or Section 521
- An organization seeking a determination letter from the IRS recognizing tax-exempt status under I.R.C. §521 may also electronically submit Form 1024
- Practitioner Note – Optional Filing
- An organization seeking a determination letter from the IRS recognizing tax-exempt status under I.R.C. §501(c)(4) can electronically submit a completed Form 1024-A

Form 1024 & 1024-A Application P. 173

- Section 501(c)(3) organizations seeking to be recognized as described in section 501(c)(4) are subject to the same requirement to file Form 8976 within 60 days of formation as new section 501(c)(4) organizations.
- An organization previously described in section 501(c)(3) that submits Form 8976 within 60 days of seeking to be described in section 501(c)(4) may have reasonable cause for not filing Form 8976 within 60 days of formation
- Such an organization may seek reasonable cause relief from any penalty for late filing Form 8976 by following the instructions in the correspondence from the IRS regarding the penalty

Issue 5

ELECTING OUT OF THE CENTRALIZED PARTNERSHIP AUDIT REGIME

Centralized Partnership Audit Regime

- Partnership returns filed for tax years beginning on or after January 2018 are subject to the centralized partnership audit rules enacted under the Bipartisan Budget Act of 2015 (BBA), Pub. L. No. 115-123
- Partnerships must designate a partnership representative on the partnership return for these years
- An eligible partnership can elect out of the new rules

Eligibility to Elect Out P. 174

- A partnership must have issued 100 or fewer K-1s for the year
- All partners must be eligible partners, which are an individual, a C corporation, a foreign entity that would be treated as a C corporation if it was domestic, an S corporation, or an estate of a deceased partner
- Eligible partners do not include partnerships, trusts, foreign entities that are not eligible foreign entities, disregarded entities, nominees or other similar persons that hold an interest on behalf of another person, and estates that are not estates of a deceased partner

How to Elect Out PP. 174-175

- The election to opt out of the centralized partnership audit regime is made on a timely filed partnership return (including extensions) for the year the election is to be effective

- A partnership must disclose to the IRS the names, correct taxpayer identification numbers (TINs), and federal tax classifications of all its partners and, if there is an S corporation partner, the names, correct TINs, and federal tax classifications of all persons to whom an S corporation partner is required to furnish statements during the S corporation partner's tax year ending with or within the partnership's tax year at issue

- A partnership electing out must notify each of its partners within 30 days of making the election

Effect of Electing Out P. 175

- An election out of the centralized partnership audit rules will subject the partnership to audits conducted under pre-TEFRA rules
- Under these rules, an examination is conducted at the partnership level for purposes of determining adjustments arising from the partnership return, but agreement or disagreement to those adjustments is solely at the partner level
- Adjustments in a partnership exam are linked to the partners' returns, and the IRS sends the partner a 30-day letter showing the computation of proposed adjustments to his or her return
- Adjustments are made only to the specific partners of the reviewed year
- The individual partner can appeal those adjustments

Effect of Electing Out P. 175

- If the partnership does not elect out, or is ineligible to do so, the IRS will conduct an examination at the partnership level
- If the examination results in an underpayment of tax, the partnership representative (PR) can elect to pay the underpayment on behalf of the partners or "push out" the underpayment, and the responsibility for payment, to the individual partners
- The PR's actions bind all the partners
- The adjustment-year partners who may not have been reviewed-year partners carry no burden, and the reviewed-year partners who may not be adjustment-year partners may be responsible for the adjustments

- The decision to elect out of the centralized partnership regime will impact the individual partners, and they should participate in deciding whether to make the election
- Practitioner Note – Partnership Agreement

Advantages to Electing Out P. 176

- Individual partners retain control over the results
- Not just one selected person makes decisions that bind all partners
- Adjustments are made only to the specific partners of the reviewed year. The adjustment-year partners who may not have been reviewed-year partners carry no burden, and the reviewed-year partners who may not be adjustment-year partners are responsible for the adjustments
- Audit adjustments are made in the audit year, not the year the audit is completed
- Once the examination is completed the partnership plays no further role
- Each partner receives a detailed computation of the proposed adjustments
- Each partner makes his or her own decision to protest or appeal the proposed adjustments
- Partners may obtain different results on appeal

Advantages to Electing Out

P. 176

- The statute of limitations for making partnership adjustments to a partner's return is determined at the partner level
- The adjustment to smaller-interest partners may never be made due to IRS tolerance levels
- A large partnership takes more resources for the IRS to audit the individual partners
- The aggregate tax liability of the partners after adjustment is more realistic than an unadjusted, imputed underpayment under the centralized rules
- Only the reviewed year's partners are adjusted, and any intervening-year adjustments are made directly on the intervening years
- There is no need for a partnership representative, and no need to provide for complicated releases of liability for and indemnification of the partnership representative

Disadvantages to Electing Out PP. 176-177

- There will be closer scrutiny of the individual partner's return when the IRS proposes the adjustments from the partnership examination
- All partners, including foreign partners, must have an identifying number to elect out
- The types of partners and number of partners is limited
- Protest and appeal of the partnership adjustments is done by each partner, raising the cost of appeal per partner and in the aggregate
- There may be different results on appeal for different partners
- Following the audit of each partner, the partnership may have to collect information about the audit and update its records
- There is nothing to protect a partnership if the IRS determines the election is invalid
- Revocation of the election requires IRS permission

Partnership Representative P. 177

Partnerships must designate a partnership representative

- Designation must be made on Form 1065, U.S. Return of Partnership Income
- Designation is made for year in which it relates and effective when return is filed

- Practitioner Note – Due Diligence & Partnership Returns
- Practitioner Note – Power of Attorney

Changing the Partnership Rep. P. 178

- I.R.C. § 6223 regulations limit the times for changing a PR and the times for a PR to resign
- A PR designation can be changed after the IRS mails a notice of administrative proceeding (NAP) or in conjunction with the filing of a valid administrative adjustment request (AAR) by the partnership.
- A PR or DI may submit a written notification of resignation only after the IRS issues a NAP
- Treas. Reg. §301.6223-1(e)(2) allows the partnership to change the PR through revocation when the partnership is notified that the partnership return is selected for examination as part of an administrative proceeding
- The partnership can change its PR before an administrative proceeding commences

Partnership Agreement P. 178

- Most LLCs (taxed as a partnership) and partnerships will need to address issues related to the PR in their LLC operating agreements and partnership agreements
- Partners may wish to ensure participation in decision making and determine whether former partners will be mandated to pay taxes on an adjustment or whether they are relieved of that liability when they leave the partnership

Figure 5.10 sample language regarding the election out of the centralized partnership audit regime

Figure 5.11 sample language designating the PR and duties of the PR

Figure 5.12 sample language regarding adjustments

Questions?