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Officials from the IRS Tax-Exempt and Government Entities Division and the Treasury Department in recent weeks have been appearing at various conferences, explaining procedural and other changes they are making in their oversight of tax-exempt organizations.

At the TE/GE Joint Council Meeting in Baltimore in late February, TE/GE Deputy Commissioner Donna Hansberry said the IRS will revise its approach to making information document requests during examinations of exempt organizations and employee plans. The idea is to make sure IDRFs are clear and timely and less burdensome to organizations under examination, she explained. She also reported that TE/GE has completed work on a case selection model that uses Form 990, “Return of Organization Exempt From Income Tax,” and the return’s supplementary forms and schedules to identify possible issues of noncompliance for examination.

In March at the Washington Non-Profit Legal and Tax Conference an IRS tax law specialist, Elaine Leichter, said there would be some changes to Form 990 this year, including to the line that asks about groups supported by supporting organizations. She also said the IRS will work on simplifying Form 8868, “Application for Extension of Time to File an Exempt Organization Return.”

Also at the Washington program, TE/GE Commissioner Sunita Lough said IRS examination agents who discover that an exempt organization does not qualify for classification under the code section under which it is described will no longer try to determine what the correct classification should be, explaining that examination agents “are not tax advisers for an organization.” She explained how an organization that wants to change its classification can go about doing so.

The IRS is working on guidance to implement a new requirement that section 501(c)(4) organizations notify the agency of their intent to operate under that code section, according to Margaret Von Lienen, acting director of IRS exempt organizations, who spoke at the same conference. Also, the director of the IRS Whistleblower Office, Lee Martin, who spoke at the Baltimore meeting, urged whistleblowers who bring claims of possible misconduct to the IRS to be specific about their allegations.

In other developments, a House Ways and Means Committee subcommittee held a hearing to hear concerns that some colleges and universities are using rules governing their tax-exempt status to infringe on students’ free speech rights. Also, Citizens for Responsibility and Ethics in Washington has renewed its call for the IRS to investigate whether the National Rifle Association of America may have violated the law by failing to report political campaign expenditures on its information returns, and it recently made a similar complaint about the Donald J. Trump Foundation.

In the area of tax-exempt bonds, practitioners in that field have had little good to say about proposed regulations on the definition of a political subdivision. Critics have questioned the need for the proposed changes and say they could have dramatic consequences.

Paul Barton has an article quoting attorneys and other observers who suggest recent developments, such as Congress telling the IRS to stop work on political activity regulations, have made it a lot easier for social welfare organizations to be politically active without worrying about their tax exemptions.

In commentary, we have a special report by Evelyn Brody, professor at Chicago-Kent College of Law, Illinois Institute of Technology, titled “The 21st Century Fight Over Who Sets the Terms of the Charity Property Tax Exemption.” The debate, she writes, is and will continue to be “contingent, messy, and ad hoc.”

Vicky Tsilas of Ballard Spahr LLP and Lauren Mack of Reyes Kurson Ltd., in “Why Your Organization Should Care About the Final Allocation and Accounting Regulations for Bond-Financed Facilities,” discuss recently published regulations on allocation and accounting for purposes of the section 141 private activity bond restrictions.

Also, in “The Missing Tax Benefit of Donor-Advised Funds,” John R. Brooks, an associate professor at the Georgetown University Law Center, writes that donor-advised funds do not provide the tax benefits that are sometimes assumed.

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Submissions to The Exempt Organization Tax Review

If there is a development or issue affecting tax-exempt organizations and you would like to write about it, Tax Analysts encourages you to submit articles to The Exempt Organization Tax Review to be considered for publication. Send articles to my attention at fred.stokeld@taxanalysts.org. I look forward to hearing from you.

Fred Stokeld
How the tax exempt stay tax aware.

“Most charities comply with the tax laws. Of course, it’s the ones that don’t that make the headlines.”

— Fred Stokeld,
Contributing Editor
Only in the publications of Tax Analysts
April 6 – 8

*Legal Issues in Museum Administration 2016, Los Angeles.* Sponsored by ALI-CLE and the Smithsonian Institution. The program will include a tax and legislation update. For more information, go to http://www.ali-cle.org.

April 27

*Issues in Nonprofit Governance, Washington.* Sponsored by the Georgetown University Law Center’s Continuing Legal Education program. For more information, email cle@law.georgetown.edu or call 202/662-9890.

April 28 – 29

*Representing and Managing Tax-Exempt Organizations, Washington.* Sponsored by the Georgetown University Law Center’s Continuing Legal Education program. For more information, email cle@law.georgetown.edu or call 202/662-9890.

May 5 – 7

*May Meeting of the American Bar Association Section of Taxation’s Exempt Organizations Committee, Washington.* The Exempt Organizations Committee will meet Friday, May 6. For more information, go to http://www.abanet.org/tax.

May 18

*D.C. Bar Taxation Section’s Exempt Organizations Committee luncheon program, Washington.* For more information, go to http://www.dcbar.org/events.

June 27 – 29

*AICPA Not-for Profit Industry Conference, National Harbor, Md.* Sponsored by the American Institute of Certified Public Accountants. For more information, go to http://www.cpa2biz.com/Not-for-Profit.

September 29 – October 1

*Fall Meeting of the American Bar Association Section of Taxation’s Exempt Organizations Committee, Boston.* The Exempt Organizations Committee will meet Friday, September 30. For more information, go to http://www.abanet.org/tax.

October 19 – 21

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TE/GE to Revise Document Request Approach During Exams

by Fred Stokeld — fred.stokeld@taxanalysts.org and David van den Berg — david.vandenberg@taxanalysts.org

The IRS Tax-Exempt and Government Entities Division is preparing to revise its approach to making information document requests (IDRs) during examinations of exempt organizations and employee plans in an effort to reduce burdens on organizations under exam, according to officials with the division.

Donna Hansberry, TE/GE deputy commissioner, said the division wants to make sure its IDRs are clear and timely. “The better we are at being clear and timely in our requests, the less the burden there should be on the organization being examined,” she said February 26 in Baltimore at the TE/GE Joint Council Meeting.

That may be more difficult than it seems, Hansberry continued. “It’s a very simple concept, but it’s a very tough thing to do,” she said. “I think for any of us who’ve spent time on either side of the aisle — asking for information, sending out requests for documents, interrogatories, what have you — it’s very difficult to ensure that what you’re asking for is very clear and precise.” Nevertheless, she added, “we’re working very hard to do as good a job as we can in that area.”

During a later session in Baltimore, Margaret Von Lienen, acting director of EOIs in TE/GE, said customer satisfaction surveys and internal quality reviews have identified the IDR process as a “pain point” for taxpayers. “Over the past year, we’ve had a team working on the IDR process, and we’re getting ready to roll out a revised process for that,” she said.

What the agency wants from the new process is for agents to ensure that IDRs are clear, concise, and tailored to the organization under audit and that they are communicating with taxpayers to make sure they understand what’s being sought and why, Von Lienen said. The IRS will implement “an enforcement piece on the IDR” to provide a tool for agents working with non-responsive taxpayers, she said.

The new IDR process in TE/GE will be similar to the one the Large Business and International Division uses, Von Lienen said. “The LB&I process is designed to put some very strict rigidity in place with a potential endgame for the issuance of summonses,” said Thomas Kane, TE/GE division counsel. (At the Baltimore program it was also announced that Kane has been selected as the new division counsel for the IRS Large Business and International Division.)

The different types of taxpayers, the volume, the size, and the time it takes to enforce a summons are different for the TE/GE taxpayer base than for the LB&I base, Kane said. Those factors are why TE/GE’s plans are more user friendly “than what people have been saying — not that it’s necessarily true but what people have been saying — about the LB&I process.”

Case Selection Model

Hansberry said TE/GE has finalized a case selection model that uses Form 990, “Return of Organization Exempt From Income Tax,” and the return’s supplementary forms and schedules to identify possible issues of noncompliance for examination.

The idea is to look objectively at multiple factors to identify potential risk so that cases better identify noncompliance and examinations are more focused, Hansberry explained, adding that in the past two years, examinations selected through this model realized an overall change rate of more than 90 percent. She said the IRS will add similar models for Form 990-PF, “Return of Private Foundation,” and Form 990-EZ, “Short Form Return of Organization Exempt From Income Tax.”

Von Lienen said that at the end of January the agency also expanded the post-determination compliance program it started in 2015 to include organizations that received their recognition of exemption after submitting Form 1023-EZ, “Streamlined Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code.” Post-determination exams are done by correspondence, she said.

“Our goal for 2016 is about 7,000 examinations,” said Von Lienen.

In general, the EO division plans more examinations in 2016, Von Lienen said. In 2014 there were around 8,000 examinations completed; in 2015 that number dropped to about 6,300. “Our goal for 2016 is about 7,000 examinations,” she said.

TE/GE expects to soon launch a tool that will automate the redacting of nondisclosable information such as Social Security numbers from electronically filed EO returns. Hansberry said the objective is to make the returns available to the public in machine-readable format.

Hansberry said that at the beginning of the current fiscal year, 30 TE/GE agents and their managers were reassigned from the EO determinations function to examinations. The move is in line with TE/GE’s efforts to put more resources on the back end, after organizations have been operating awhile, rather than on the front end.
when organizations are just starting out and are talking about what they plan to do, she said.

Healthcare

With the issuance of regulations under section 501(r) and the implementation of the 2015 and 2016 provisions of the Affordable Care Act, TE/GE is shifting some resources to its mandated reviews of tax-exempt hospitals as the list of items it is required to check grows and more in-depth reviews are required to ensure hospitals are complying with ACA requirements, Hansberry said. The reviews will continue to take place without contact from the IRS, unless noncompliance is uncovered or something needs clarification, she said.

“Depending on the issue, this may generate an examination or a simpler compliance check contact,” Hansberry said.

Some of those examinations are expected to begin in 2016, Von Lienen said.

Hansberry said the IRS recently posted to its website several “issue snapshots” derived from TE/GE’s knowledge management efforts, including one about section 4942 taxes on failure to distribute income. The postings reflect TE/GE’s intention to eventually open its document libraries to the public, she said.

ABLE Account Regs

The IRS is working on final regulations under the Achieving a Better Life Experience (ABLE) Act and hopes to release them in the summer, said Janine Cook, IRS deputy associate chief counsel (TE/GE).

The ABLE Act passed in December 2014 as part of the Tax Increase Prevention Act of 2014. It allows states to establish tax-favored savings programs similar to section 529 plans. The section 529A plans can receive contributions for eligible disabled individuals, who can then use those funds to pay qualified disability expenses. The IRS released proposed regs (REG-102837-15) in June 2015 and received more than 200 comments addressing issues raised by the rules.

“There were a few things that were really causing some concern to the states as they were proceeding along this path, and they were basically telling us we’re not sure we can go forward as long as these three things are there,” Cook said. The proposed regs were meant to ensure that those concerns, including the requirement to collect contributors’ taxpayer identification numbers, would be dealt with in final regs, Cook said. Programs won’t have to get the TINs upfront, she said.

No Material Form 990 Changes In 2015; Some for 2016

by David van den Berg — david.vandenberg@taxanalysts.org

Although there were no material changes to Form 990, “Return of Organization Exempt From Income Tax,” for 2015, changes are in the works for 2016, an IRS representative said March 17.

Elaine Leichter, tax law specialist (rulings and agreements), IRS Tax-Exempt and Government Entities Division, mentioned one small change while speaking at the Washington Non-Profit and Tax Conference. As a result of erroneous filings, the IRS will change line 11g, column iii, the entry for type of organization. Lines 1 through 9 are the bases for public charity status.

Leichter later told Tax Analysts that line 11g, column iii captures information about the groups supported by supporting organizations and that there was a high error rate in that field because some organizations were not indicating the type of public charity they were supporting and were simply indicating they supported a section 501(c)(3) organization.

Changes will also be made to the 2015 instructions following Treasury finalizing section 501(r) regulations, Leichter said.

For 2016, the noncompliant hospital facility tax will affect Form 990-T, “Exempt Organization Business Income Tax Return,” and requires adding a line, Leichter said.

“If a hospital fails the test under 501(r) . . . it doesn’t mean that the activities are unrelated to the organization’s exempt purpose,” Leichter said. It’s not unrelated business income tax, she said, “so we needed a new line to capture it.”

The other big change for 2016 will be to simplify Form 8868, “Application for Extension of Time to File an Exempt Organization Return.” Leichter said a transportation bill passed in July 2015 (P.L. 114-41) changed the allowed automatic filing extension period to six months.

TE/GE is facing budgetary constraints, which hinder the division’s efforts to keep forms up to date and mean suggestions might only lead to changes in instructions, Leichter said, adding later that the agency still welcomes feedback.

“These days, suggestions for improvements aren’t a basis for changing a form,” Leichter said. “It’s actually quite expensive to change a form.”

That’s because with modernized e-file, the agency has both electronic and paper versions of forms and must keep them consistent with each other while navigating different systems, Leichter explained.
Exam Agents Cannot Reclassify EOs

by Fred Stokeld — fred.stokeld@taxanalysts.org

IRS examination agents that discover a tax-exempt organization does not qualify for classification under the code section under which it is described will inform the organization about the lack of qualification but will no longer try to determine what the correct classification should be, an official with the agency said March 18.

Sunita Lough, commissioner of the Tax-Exempt and Government Entities Division, said that when this situation arose in the past, the exam agent would typically advise the organization of the correct classification. But as part of TE/GE’s efforts to enhance effectiveness and efficiency, agents from now on will continue to inform the organization that it does not qualify under its code section but will no longer say what the correct exemption category might be.

Examination agents, Lough explained, “are not tax advisers for an organization. We are there to provide education, we’re there to provide services, but providing tax advice [on what an organization’s classification should be] is, in our opinion, stepping over the line.”

If an organization wants to change its exemption category after learning it does not qualify under its existing classification, it must reapply for exemption or declare itself exempt as an organization described under a new section, and the examination agent can talk with IRS determinations personnel to resolve the case, Lough said. “But an exam agent . . . cannot grant an exemption to an organization in the exam process,” she added. “An agent cannot say ‘you are a [section 501(c)(6) entity], so I’m just going to give [that classification] to you’ or I’m just going to agree you’re a (c)(6).”

An organization that reapplies also will have to pay a new user fee, according to Lough.

Janine Cook, IRS deputy associate chief counsel (tax-exempt and government entities), who spoke about recent changes to annual revenue procedures and processing private letter rulings, urged practitioners submitting letter ruling requests to carefully review the revenue procedure (Rev. Proc. 2016-8, 2016-1 IRB 243) on user fees to ensure the correct fee is paid. Paying the wrong fee, she said, could delay the processing of a request by as much as a month.

Also, some taxpayers mistakenly think they can request rulings for a private foundation and an individual but pay just one user fee; actually, two user fees must be paid, Cook said.

501(c)(4) Notification Regs in the Works

by David van den Berg — david.vandenberg@taxanalysts.org

The IRS is developing regulations to implement a requirement in the tax extenders and government funding legislation signed into law in December 2015 that section 501(c)(4) organizations notify the agency of their intent to operate under that code section, an IRS official said March 17.

“And until the regulations are issued we’re asking the organizations not to file anything with us,” said Margaret Von Lienen, acting director of exempt organizations in the Tax-Exempt and Government Entities Division, during a luncheon at the Washington Non-Profit Legal and Tax Conference.

In January the IRS issued Notice 2016-9, 2016-6 IRB 306, which said organizations will have 60 days from the date temporary regulations on the notification requirement are issued to notify the IRS. Section 506, which contains the notification requirement, was added to the code in December 2015 by the extenders law (P.L. 114-113).

While section 506 requires the IRS to send an acknowledgment of the organization’s notification, that acknowledgment won’t be a determination that the organization qualifies for exemption. Organizations can request that determination separately, and until guidance is issued they should use Form 1024, “Application for Recognition of Exemption Under Section 501(a),” to do that, she said.

The tax extenders legislation also had a significant effect on several forms and publications regarding EOs, and work is underway to update them, Von Lienen said.

TE/GE is revising its website and trying to ease navigation after receiving complaints about it, Von Lienen said. The EOs landing page will look similar to the employee plans landing page, which has already been updated, she said.

“Hopefully we can make those changes soon so it will be easier for people to be able to find the resources that they need,” Von Lienen said.
Whistleblowers Should Be Specific, IRS Official Says

by Fred Stokeld — fred.stokeld@taxanalysts.org

Whistleblowers bringing claims of possible misconduct to the IRS should be “very specific” about the alleged wrongdoing, an IRS official said February 26.

When the IRS denies whistleblower claims, it’s usually because the claims have not made a sufficient case that there may have been an underreporting of tax or a violation of the code, said Lee Martin, director of the IRS Whistleblower Office. “If it doesn’t involve underreporting of a tax or a violation of the Internal Revenue Code, then it may be something that we would classify as speculative, non-credible,” said Martin, who spoke in Baltimore at a joint meeting of regional tax-exempt and government entities councils. “The most common reason for our closures is . . . the information is not specific, it’s not credible, or it’s very speculative in nature.”

Therefore, whistleblowers should provide details when submitting their claims. “Tell us what you think it is, and we will make the determination,” Martin said. “Be very specific.”

Martin provided other reasons claims may be denied. The IRS might already have the information provided by the whistleblower, or the agency may lack the resources to address it. There also may not be enough time remaining on the statutes of limitation, the statute may have run out before the IRS received the claim, or the issues raised “might be below our IRS threshold,” he said.

The IRS might turn down a claim if the examination or the whistleblower’s issues result in a “no change” determination or if the whistleblower failed to file Form 211, “Application for Reward for Original Information,” according to Martin, who added that the IRS may also reject a claim if there are no collected proceeds.

Martin said his office has begun a Lean Six Sigma initiative that is “looking at everything that we can to improve the award payout process.” Lean Six Sigma is a management engineering method used to optimize business performance. Martin is also looking into the possibility of allowing Form 211 to be submitted electronically or by fax.

No Stopping Political Nonprofits Now, Some Say

by Paul C. Barton — paul.barton@taxanalysts.org

If perception is reality, the new reality for nonprofit social welfare organizations is that they can emphasize politics as much as they want and not worry about losing their tax exemptions.

That’s what some academics, nonprofit attorneys, watchdog groups, and other observers perceive in the wake of three recent developments affecting groups claiming tax exemptions under section 501(c)(4):

• The February 9 disclosure by the Center for Responsive Politics that in November 2015 the IRS quietly approved the exemption application for Crossroads GPS, widely considered the nation’s most prominent politically oriented 501(c)(4) group, founded in 2010 by Republican operatives Karl Rove and Ed Gillespie. The approval of the five-year-old application means the IRS now considers Crossroads a social welfare group. (Prior coverage: The Exempt Organization Tax Review, Mar. 2016, p. 176.)

• Congress in December approving language that forbids the IRS from further work in fiscal 2016 on new rules to regulate political activity by section 501(c)(4) organizations. That provision was enacted as part of the omnibus spending and tax extenders bill (P.L. 114-113).

• Congress, in the same bill, including language making it clearer than ever that a group wanting to operate as a section 501(c)(4) need no longer “apply” for that designation. It can simply start operating and, within 60 days, send in a simple registration form telling the IRS that it claims that status. However, it still must file a Form 990, “Return of Organization Exempt From Income Tax,” and could be asked to provide supporting documentation.

But IRS audits of section 501(c)(4) groups are extremely rare, the Center for Public Integrity found in a 2015 review.

As for Crossroads, “regardless of the actual merits of [its] application, the granting of the application will be perceived by many as removing whatever barriers remained to the use of 501(c)(4)s as vehicles for supporting some candidates,” Lloyd Hitoshi Mayer, Notre Dame law professor, told Tax Analysts.

Advocates of campaign finance reform who have been searching for ways to contain what they see as abuse of social welfare groups for political purposes are stunned.

They contend that the Forms 990 filed by Crossroads show an organization that takes in hundreds of millions of dollars per election cycle and regularly spends right up to or more than 50 percent of its funds on trying to influence elections. They say that couldn’t have been what Congress had in mind when it established tax-exempt categories more than 100 years ago. Federal law says section 501(c)(4)s are to be engaged in social welfare purposes exclusively, but IRS guidelines require that only 51 percent of their budgets be spent on social welfare.
Now, not only is the barn door open for more political activity by social welfare groups, but “this [Crossroads] decision took the doors off the barn,” said Fred Wertheimer, head of Democracy 21.

“It [Crossroads GPS] is a ridiculous and unfortunate decision,” said Paul S. Ryan of the Campaign Legal Center. According to Craig Holman of Public Citizen, the IRS made a “grave mistake.”

Conservatives Happy

“We have always taken compliance very seriously, so we’re not surprised by the final result,” Steven Law, president of Crossroads, told The Washington Post about getting IRS approval. “What we were surprised by was how long it took and how people outside the IRS improperly tried to influence and politicize the process, not just against us but against many other law-abiding advocacy groups.”

And those who have long argued that the IRS has no business interpreting when a group is involved in political speech and when it isn’t couldn’t be happier. They also celebrate Congress bringing to a halt the agency’s work on new rules on campaign intervention for nonprofits, which began in November 2013.

“Those expressing outrage are many of the same groups that helped create the IRS targeting scandal in the first place,” said David Keating, president of the Center for Competitive Politics. “They put enormous pressure on the agency to ‘do something,’ and that led to disaster.” He added, “The recent move into political regulation has embroiled the IRS in political fights the Service should avoid.”

Mayer said the application scandal involving Tea Party and other groups demonstrated that “the tax law and the IRS are poorly equipped to regulate political activity, and it is disastrous when they are forced to do so.”

Those expressing outrage are many of the same groups that helped create the IRS targeting scandal in the first place, Keating said.

Those who are outraged are professionally and perennially outraged at the notion that conservative voices might be heard on issues, causes, or candidates. They hate that,” said Cleta Mitchell of Foley & Lardner LLP, who represents several conservative groups involved in the exempt organizations controversy.

The new registration option for 501(c)(4) groups to begin operating more easily was added good news, Mitchell said. “It was never intended that the application process at the front end would be some sort of advance program review. That is what the IRS did to the Tea Party groups, which had never been done before,” she said.

The change was a little-noticed aspect of the omnibus spending bill, Mitchell said. “Now it is clear that because of this provision,” Form 1024, “Application for Recognition of Exemption,” is not necessary, she said. “It was not so clear previously unless you really knew what was going on. In the future, people would be nuts to file one.”

Even though a self-declare option existed before, many groups still wanted to go through the approval process to reassure their donors of their status.

The new process will help groups meet the requirements of state agencies that track nonprofits, Mitchell said. She said those agencies will often ask for a copy of the IRS approval letter or its Form 1024, and for a self-declared group, “that gets to be dicey.” Now, she said, “a group can just send a copy of its registration form.”

But others don’t see the new registration process as that big a deal. “The new process doesn’t change anything except to require early registration with the IRS,” said Elizabeth J. Kingsley of Harmon, Curran, Spielberg + Eisenberg LLP. “So a group that forms for a single election period would still owe [a Form 990] for that year, even if dissolved before the next fiscal year — just as in the past. It’s just that now, there is at least some record of their existence and claim to 501(c)(4) status that’s public long before the first [Form] 990 is filed.”

2016 Impact

Long before the IRS ruling on Crossroads, watchdog groups were predicting an inordinate impact on the 2016 elections from section 501(c)(4) groups, knowing how political strategists prized their ability to protect donors’ identities.

By mid-2015, eight of the original 17 Republicans launching presidential campaigns were linked to section 501(c)(4) groups that paid for messages providing favorable publicity for them. (Prior coverage: The Exempt Organization Tax Review, Oct. 2015, p. 390.) In doing so, they attempted to walk the tightrope separating “issue advocacy,” discussing a candidate’s actions on a particular issue, from “express advocacy,” explicitly urging the candidate’s election or defeat.

Also in 2015, watchdog groups complained to the IRS about the Conservative Solutions Project, a section 501(c)(4) organization linked to Florida Republican Sen. Marco Rubio, and Carolina Rising, a section 501(c)(4) group linked to North Carolina Republican Sen. Thom Tillis’s 2014 election. Both had spent so much on campaign-related advertising that violations of tax law were undeniable, it charged. In the case of Carolina Rising, political activity was 97 percent of its budget, the Center for Responsive Politics reported. Meanwhile, the Rubio-related group, operating during his presidential campaign, spent more than $8 million on ads favorable to the Florida senator, at one point making it the second largest buyer of political ads in the 2016 presidential race, according to Kantar Media. Still another section 501(c)(4) group, Heartland Principles, “candidly admitted that it engaged almost exclusively in political activity,” Mayer said of the group’s most recent Form 990.

And now there is a section 501(c)(4) group called Every Citizen Counts supporting Democratic presidential contender Hillary Clinton’s campaign, despite her calls to remove anonymous funding — or “dark money” — from U.S. politics. The Clinton campaign declined requests for comment.

For the rest of the 2016 elections, many observers fear, all of the relevant federal agencies — the IRS, the Federal
Electors Commission, the SEC, and the Federal Communications Commission — will remain reckless in the face of continued section 501(c)(4) group spending on behalf of 2016 candidates at all levels.

Observers note that after it launches, a 501(c)(4) doesn’t have to file a Form 990 for 16½ months, not counting easily obtainable extensions. As a result, groups could form to influence 2016 races and disband before ever having to file their returns.

And that is exactly what Robert Maguire, lead nonprofits investigator for the Center for Responsive Politics, expects to happen. Maguire told Tax Analysts that he expects some of the larger organizations to form “satellite groups” that target particular races, which would then “fade away.”

Heartland Principles ‘candidly admitted that it engaged almost exclusively in political activity,’ Mayer said of the group’s most recent Form 990.

“Carolina Rising is the perfect example of that,” Maguire said, adding that records show it got almost all of its funding from Crossroads. While groups like Crossroads do not have to disclose who donates to them, they do have to show where they donated their funds.

Another concern is that an absence of 501(c)(4) regulation provides an opening for foreign money to influence U.S. elections. Keating agreed that that is something for the FEC to worry about. “However, I’m pretty sure that if any such money is received, as long as it is put in a separate segregated account and not used for any independent [election] expenditures, that is probably fine,” he said.

What’s Next?

After what they regard as gloomy news of late, campaign reform advocates ponder where to go from here. “It’s not clear,” Wertheimer said, but he added, “No one is walking away from this fight.”

One possibility is a court decision that would force the FEC to examine section 501(c)(4) groups and require those that spend heavily on politics to register as political committees under section 527 of the tax code, which would also require them to disclose donors. Public Citizen has a pending lawsuit against the FEC in the U.S. District Court for the District of Columbia, accusing the commission of neglecting its oversight duties in December 2013 by not requiring Crossroads to disclose its donors. The FEC ignored the recommendations of its staff that Crossroads be treated as a “political committee,” requiring those disclosures.

“What I’m counting on is that a number of Crossroads and IRS records used in the application [for 501(c)(4) status] are about to be made public,” Holman said. “We may find some useful information for the lawsuit.”

Another possibility, warns Gregory L. Colvin of Adler & Colvin, is that a section 527 group, calling its activities similar to those of a political section 501(c)(4) group, will go to court claiming that because it has to disclose donors, it is a victim of disparate treatment under tax laws. If it is successful, the “big-money, no-transparency character of our campaign finance system will spin even further out of control,” he said.

Reformers had hoped President Obama would have acted by now. They have pleaded with him to issue an executive order requiring federal contractors to disclose their political contributions, including those made to section 501(c)(4) groups. They had also hoped that the SEC would require companies to make those disclosures to shareholders and that the FCC would have required broadcast stations to disclose the true funders behind political ads.

Watchdog groups have also tried to interest the Justice Department in investigating section 501(c)(4) groups. “The Department of Justice is one agency with authority to prosecute criminal violations of our tax and campaign finance laws,” said Stephen Spaulding, attorney for Common Cause. But the Justice Department has repeatedly declined to get involved, saying those cases are IRS matters.

At any time, Congress could outlaw nonprofits’ involvement in politics by rewriting federal campaign laws, reform advocates say. But they don’t expect that to happen as long as Congress remains under Republican control. Dark money has overwhelmingly favored conservative candidates and causes since the Supreme Court’s 2010 decision in Citizens United v. FEC, the Center for Responsive Politics said.

“Ultimately, it’s going to take comprehensive action on the part of Congress, the president, and agencies like the IRS, FEC, FCC, and SEC to fully shine a light on secret money in our elections,” Spaulding said. “There is no single solution.”

On the other hand, groups favoring the involvement of section 501(c)(4) organizations in politics are hoping Congress will cement campaign law in their favor. A group calling itself the Tax Revolution Institute wants lawmakers to make permanent the freeze they put on the IRS rulemaking.

“If Supreme Court rulings clearly defining political activity have not been enough for the IRS, then we agree the law should be explicit,” said Dan Johnson, executive director of the group. “However, this clarity must follow Supreme Court jurisprudence on the issue instead of limiting constitutionally protected speech. Neither Congress nor the IRS should excuse severe limits on free speech as simple clarifications to nonprofit rules.”

Meanwhile, those involved in the Bright Lines Project, a collaboration between Public Citizen and interest groups nationwide to clarify the rules on nonprofits, say their work should continue.

“Absolutely, the Bright Lines Project is pursuing a pivotal reform,” Colvin said. “The ability of the IRS to articulate and enforce a universal definition of political intervention, applicable to all the organizations and taxpayers covered by the Internal Revenue Code, whether they operate at the federal, state, or local level, turns upon finishing the work started in November 2013.”

“That work product should be released as soon as possible, so that the public can comment upon it, testify at public hearings, and make it the best it can be,” Colvin said.
Hearing Looks at Use of Tax Code to Stifle Campus Speech

by Fred Stokeld — fred.stokeld@taxanalysts.org

The debate over free speech on college campuses made its way to Congress on March 2, when Republicans at a House Ways and Means subcommittee hearing expressed concern that some schools are using the tax code to keep students from expressing their views while Democrats derided the session as a waste of time.

At a hearing of the Oversight Subcommittee, Chair Peter J. Roskam, R-Ill., said many colleges and universities invoke their status under section 501(c)(3), which prohibits partisan political campaign intervention, to stifle political speech on campus, particularly during election years. He cited the example of one of the hearing’s witnesses, Alexander Atkins, a Georgetown University Law Center student who said he was told by the school that because Georgetown is a tax-exempt organization classified under section 501(c)(3), he could not distribute literature promoting the presidential candidate of his choice on campus.

Although Georgetown subsequently announced it would revise its policies to permit some partisan activities, other schools continue to use section 501(c)(3) as an excuse to restrict political speech, Roskam said.

“But let’s get something straight: Section 501(c)(3) does not require schools to prohibit student political activity on campus,” Roskam said.

Confusion over IRS guidelines is the likely cause of this “censorship,” said Catherine Sevcenko of the Foundation for Individual Rights in Education. “General counsels are not going to allow political activity that they fear will endanger their schools’ tax-exempt status,” she told the subcommittee. “As long as the IRS guidance is ambiguous, censorship will win out every time.” She said clear guidance saying partisan political activity on campus by students, faculty, and staff will not threaten a school’s exemption as long as the activists do not claim to speak for the school “would be a huge step forward in preserving free speech on campus.”

But Frances R. Hill of the University of Miami School of Law said the IRS has published “quite clear guidance” on campus political activity and has made it “abundantly clear” that only rarely would a student be considered the agent of a university.

‘Section 501(c)(3) does not require schools to prohibit student political activity on campus,’ Roskam said.

“Section 501(c)(3) does not apply to the students, the faculty, or the administrators,” Hill said. “It applies to the university as a tax-exempt entity.” She added that while “students can do almost anything,” there would be a problem if a college or university senior administrator endorsed a candidate without making it clear that the administrator was acting in a personal capacity.

Hill urged the panel to look carefully at existing guidance and suggested colleges and universities review it so that they can educate their administrators and presidents about what they can and cannot do.

Several Democrats on the subcommittee asked why the hearing was being held in the first place. The panel’s ranking minority member, Rep. John Lewis, D-Ga., said the subcommittee lacks jurisdiction over alleged bias on college campuses, freedom of speech, future legislation, or proposed changes to the code. The subcommittee should be looking at taxpayer rights instead, Lewis said.

Rep. Joseph Crowley, D-N.Y., said the panel was “searching for a problem where no problem exists.” The subcommittee should be addressing other issues, such as

**WATCHDOG RENEWS CALL FOR IRS PROBE OF NRA**

For the third time since June, a watchdog organization asked the IRS to investigate the National Rifle Association of America, again contending that the tax-exempt gun rights group may have broken the law by spending millions of dollars on political campaign activities without reporting the expenditures on its IRS information returns.

In a March 8 letter to IRS Commissioner John Koskinen, Noah Bookbinder, executive director of Citizens for Responsibility and Ethics in Washington (CREW), said that between 2008 and 2014, the NRA, a section 501(c)(4) entity, contributed approximately $1 million to five section 527 political groups, both Republican and Democratic, though the Republican groups received the most money. Those expenditures were not reported to the IRS as required by law, according to Bookbinder.

“As a result, it appears the tax returns were false and incorrect as to the material matter of the amount of money the NRA spent on political campaign activities in those tax years,” Bookbinder wrote. He repeated his request for an IRS probe and said that if the agency finds the NRA made false or incomplete statements on its returns, it should “take appropriate action,” including but not limited to referring the matter to the Justice Department for prosecution.

In a June 2015 letter and in a follow-up letter to the IRS in January, CREW said the NRA appeared to have violated federal law by failing to disclose more than $33.5 million in political activity expenditures made between 2008 and 2013. (Prior coverage: The Exempt Organization Tax Review, Feb. 2016, p. 114.)

The NRA had not responded to a request for comment by press time.

— Fred Stokeld
taxpayer identification theft and the impact of budget cuts on IRS customer service, he said.

Roskam defended the decision to hold the hearing, arguing that using section 501(c)(3) to stifle free speech is a legitimate issue for the subcommittee to address. Moreover, because that activity is being subsidized through schools’ exempt status, it is reasonable to look into it, he said.

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Ways and Means Tax Counsel Sees Window for Tax Reform in 2017

by Fred Stokeld — fred.stokeld@taxanalysts.org

House leaders remain interested in discussing new ideas on tax reform, a Ways and Means Committee aide confirmed March 18, but a Republican lawmaker said he does not expect Congress to make much progress on the issue this year.

Harold Hancock, majority tax counsel to the Ways and Means Committee, said he believes House Speaker Paul D. Ryan, R-Wis., and Ways and Means Chair Kevin Brady, R-Texas, are looking at 2017 “as a window for doing tax reform” and that Brady is interested in “setting the conversation” on the topic. Therefore, anyone with ideas on reforming the tax system should share them with the committee before then, he said at the Washington Non-Profit Legal and Tax Conference.

“We are very much in a listening mode for ideas of all kinds,” Hancock said.

When panel moderator Joanne Florino of the Philanthropy Roundtable asked whether proposals in the tax reform draft floated by former Ways and Means Chair Dave Camp involving tax-exempt organizations and charitable giving remain in play, Hancock said the draft still represents issues of interest to committee members and was a starting point for a discussion.

Rep. John J. Duncan Jr., R-Tenn., speaking at the same event, was less optimistic about reform happening in 2016.

Although about 85 percent of Americans want a simpler tax system, such as the FairTax or a flat tax, tax reform is probably the most difficult issue for Congress to address, said Duncan. “We’ve been able to pass almost anything else except for that,” he said. “I think it’s pretty certain that we’re not going to do much [on tax reform] this year.”

He added, however, that if Republicans retain control of Congress in the 2016 elections and retake the White House, things could be different. “I think we would see major changes on all kinds of things,” Duncan said.

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IRS Political Subdivision Proposal Could Be Controversial

by Fred Stokeld — fred.stokeld@taxanalysts.org

Nearly three years after publishing a technical advice memorandum that some critics have said is at odds with the commonly understood standard for political subdivisions for purposes of tax-exempt bonds, the IRS has published proposed regulations on political subdivisions that could prove just as controversial.

According to the preamble of the proposed regs (REG-129067-15), released February 22, in order to qualify as a political subdivision, an entity must be governmentally controlled, with control defined as ongoing rights or power to direct significant actions of the entity. In general, the control must be vested either in a general purpose state or local governmental unit or in an electorate established under applicable state or local law. An entity controlled by an electorate would not be governmentally controlled when the outcome of exercising that control is determined solely by the votes of an “unreasonably small number of private persons,” the proposed regs say.

A political subdivision must also serve a governmental purpose and provide a significant public benefit, with no more than incidental benefit to private persons. The proposed regs retain the existing requirement that a political subdivision have the ability to exercise at least one sovereign power — eminent domain, police power, or taxing power. (The proposed regs are reprinted at p. 299.)

Vicky Tsilas of Ballard Spahr LLP, who from 2012 through 2014 worked on tax-exempt bond issues at Treasury but was not involved in drafting the new proposal, told Tax Analysts that the proposed regs got their start following the publication of TAM-127670-12 in 2013. According to the memorandum, a community development district established under a town ordinance was not a political subdivision at any time when the district issued bonds to acquire assets from a developer, because it was not a division of a state or local governmental unit during that period.

The memorandum drew a heated response from critics, including some members of Congress, who believed the IRS was changing the commonly understood definition of a political subdivision and could kill the financing of infrastructure in rural areas by preventing developers from initially setting up infrastructure projects before bonds are issued to finance the construction, Tsilas said.

Critics called for guidance to clarify the definition and to give people a chance to voice their opinions. In an article published by Tax Analysts several months after the publication of the technical advice memorandum, Ellen F. Aprill of Loyola Law School said that type of “unprecedented and radical change” should be presented in a format allowing for public comment.

When asked about the proposed regs, Aprill said she is glad that the IRS and Treasury are now providing an opportunity to comment and that the proposed regs
request comments on the impact the proposed definition of governmental control might have on development districts.

'This is a biggie because, in my mind, it is a complete change on defining control and how these deals are done,' Tsilas said.

Tsilas said the proposed regs’ definition of a political subdivision is “a completely different standard” that will generate a lot of comments. “I suspect it’s going to get a lot of critque from folks saying, ‘Wait a minute, why are you now completely changing the playing field?’” she said. “This is a biggie because, in my mind, it is a complete change on defining control and how these deals are done.”

A public hearing on the proposed regs has been scheduled for June 6 at IRS headquarters in Washington.

Political Subdivision Proposal Gets Frosty Reception

by Fred Stokeld — fred.stokeld@taxanalysts.org

Officials from the IRS and Treasury on March 10 endured tough criticism of recently proposed guidance on the definition of a political subdivision, with critics lambasting the proposal as misguided.

At a program in Washington sponsored by the National Association of Bond Lawyers (NABL), bond counsel on the panel and in the audience panned REG-129067-15, which Treasury and the IRS released February 22. Critics questioned the need for the proposed changes and warned that they could have dramatic results down the road.

To qualify as a political subdivision, an entity must be governmentally controlled, with control defined as ongoing rights or power to direct significant actions of the entity, according to the preamble of the proposed regulations. In general, the control must be vested either in a general purpose state or local governmental unit or in an electorate established under applicable state or local law.

An entity controlled by an electorate would not be governmentally controlled when the outcome of exercising that control is determined solely by the votes of an “unreasonably small number of private persons,” the proposed regs say.

Also, a political subdivision would have to serve a governmental purpose and provide a significant public benefit, with no more than incidental benefit to private persons. The proposal also retains a requirement that a political subdivision be empowered to exercise at least one sovereign power — eminent domain, police, or taxing power.

The day before the NABL meeting, Treasury and the IRS amended the applicability dates of the proposed definition to provide transition rules for bonds issued before the general applicability date and some refunding bonds. (The proposed regs are reprinted at p. 299 and the amendment on p. 304.)

The correction appeared to do nothing to mollify the lawyers at the NABL event. Panel moderator Michael Larsen of Parker Poe Adams & Bernstein LLP said that although the preamble to the proposed regs talks about the need to clarify the definition in order to provide more clarity, he doubted there was much uncertainty to begin with. “Was it really uncertain?” Larsen asked. “Was the definition not clear?”

In response, John J. Cross III, Treasury associate tax legislative counsel, said that although it is assumed that states do not give away their taxing, eminent domain, or police powers lightly, recent audit activity exposed a potential vulnerability to that assumption that raised serious concerns at the highest levels of government.

“I think policy officials felt it was important to stake out the point that . . . you need to have core governmental characteristics, just like any other kind of governmental entity,” Cross said. “I think we feel it’s a really principled point to say of course a governmental entity that’s a political subdivision needs to have a governmental purpose and be under governmental control.”
Panelist Mitchell Rapaport of Nixon Peabody LLP expressed surprise that proposed guidance that would make “wholesale, dramatic changes” has been published to address a problem involving what he thinks is a “very narrow slice” of the many existing governmental entities. If enacted in its current form, the proposal could have dramatic effects in a year or two, he added.

Cross replied that “the notion that having three private individuals controlling a governmental entity is going to have a widespread effect [is] problematic.” He added that although the government does not believe the problem addressed by the proposed regs is significant, “we believe there is a vulnerability with potential unduly concentrated control of governmental entities.”

'I think policy officials felt it was important to stake out the point that you need to have core governmental characteristics, just like any other kind of governmental entity,’ Cross said.

Larsen said the language about public purpose and the passage about providing a significant public benefit with no more than incidental private benefit might suggest a second private use test that would have to be applied to deals, “because we could, potentially, have an entity that may have a governmental purpose, but you’ve got a water district somewhere that’s serving private landowners. And that area of law is incredibly unclear.”

Cross explained that this standard was drawn from the essential governmental function test in section 115, “where it has a long-standing, sort of flexible standard but has that concept as part of that.”

Cross, who was joined by Spence W. Hanemann of the IRS Office of Chief Counsel, said Treasury and the IRS welcome comments on the proposed regs.

More Guidance Coming

Cross also discussed other guidance in the works on tax-exempt bonds, one piece of which focuses on management contract safe harbors. “We’re looking at longer terms, considering whether or not we might have some outer boundary that is longer than the 15 or 20 years now, perhaps some different number of years but maybe tied to an economic life constraint,” he explained.

Another project involves change-in-use remedies, Cross said, noting that Treasury and the IRS have received a lot of questions about leases and what should be done with longer-term private leases.

In the area of issue price, Treasury and the IRS are looking at themes addressed in the comments that have been submitted, including whether “we should do something special for competitive sales,” Cross said.

Treasury and the IRS at some point hope to come up with a proposal regarding reissuance based on the contents of Notice 98-41, 1998-33 IRB 12, according to Cross. Also, guidance on arbitrage is “well along,” he said.

As Staff Levels Fall, IRS Bonds Team Streamlines

by Fred Stokeld — fred.stokeld@taxanalysts.org

The IRS Office of Tax-Exempt Bonds (TEB), faced with fewer employees, is taking steps to make its operations more efficient, including in the area of voluntary compliance, according to the head of the office.

TEB Director Rebecca Harrigal reported on March 10 that last year TEB lost seven people and expects to lose more this year. That will probably leave TEB’s staffing level in the low 60s, she said in an appearance at a National Association of Bond Lawyers program in Washington.

“Now from a big picture, when you look at the amount of bonds that are out there in ratio to the number of people in TEB, what’s the big deal?” Harrigal asked. “But when you start looking at the work we do in TEB, it is a big deal.”

Harrigal acknowledged that the staff reduction has resulted in fewer examinations, remarking that with fewer employees, “we’re going to do less work.” However, she cautioned against reading too much into pure numbers.

Throughout the session, Harrigal emphasized that TEB is dealing with the staff cutbacks by streamlining and standardizing operations and trying to make its processes more efficient. The office is looking at what can be cut and how it can “help issuers do self-monitoring, self-enforcement, come in on their own when there’s a problem,” she explained.

'We test effectiveness as to how early you caught the problem. The earlier you caught it, the better deal you get,’ Harrigal said.

One way TEB is streamlining its voluntary closing agreement program (VCAP) is by allowing bond issuers whose situations meet VCAP requirements to complete and sign closing agreements, compute the resolution amounts, and mail the agreements to the IRS. The option was first made available to issuers of qualified section 501(c)(3) bonds.

The simplified VCAP “tells exactly what the settlement amount should be and what [the issuers] need to pay,” Harrigal said. “The issuer just fills in the blank, pays the amount, signs three copies, sends it in. We make sure everything’s OK, we sign it, send it back, the case is done. There is no more work that needs to be done on those. [It’s] a quick way to try to get these problems flushed out of the system.”

Another modification to VCAP is encouraging self-monitoring by issuers, Harrigal said. TEB will ask issuers coming into the program “what steps they’ve taken to make sure that this problem doesn’t happen again,” she said.
Harrigal remarked that there is no standard formula in the Internal Revenue Manual for meeting any particular requirement for post-issuance compliance; the litmus test is effectiveness. “We test effectiveness as to how early you caught the problem,” she said. “The earlier you caught it, the better deal you get.”

TEB published model closing agreements, one for examinations and one for VCAP, on its website March 9. An issuer that submits a VCAP request must include a completed model closing agreement, Harrigal said.

Harrigal was asked to discuss TEB’s bondholder unit. She said TEB rarely has to approach bondholders because nearly all cases are resolved with the issuer. But if an issuer is unwilling to resolve an issue and the IRS continues to believe there is noncompliance, TEB will identify the bondholders and send them a preliminary adverse letter along with a request to extend the statute, she explained. Harrigal said finding bondholders can be difficult, sometimes necessitating the use of a summons, and that the IRS is trying to determine if the process can be simplified by using alternative information sources.

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CREW Still Wants Investigation Despite Trump Group’s Admission
by David van den Berg — david.vandenberg@taxanalysts.org

Despite aides to Republican presidential candidate Donald Trump admitting March 22 that a $25,000 donation the Donald J. Trump Foundation made to a section 527 organization was a mistake, Citizens for Responsibility and Ethics in Washington (CREW) still wants the IRS to investigate.

CREW spokesperson Jordan Libowitz said the Trump Foundation’s admission to The Washington Post that it made a donation to And Justice For All, a political organization, and did not report it on its IRS information return does not change the fact that laws may have been broken.

“Admitting that you made a mistake doesn’t negate the fact that an illegal donation was made, nor does it negate the fact that incorrect information was filed on their [Form 990-PF],” Libowitz told Tax Analysts. “It’s really best for the IRS to investigate this matter to get to the bottom of what happened and to decide what comes next.”

Noah Bookbinder of CREW filed a complaint March 21 with the IRS saying that in making the donation to the group, which was associated with Florida’s Attorney General Pam Bondi, and in failing to report it, the foundation may have broken the law. The complaint also cites news reports saying that at the time of the donation, Bondi was considering joining a lawsuit against Trump University, and ultimately decided neither to do that nor to open an investigation.

Trump’s campaign spokesperson and the foundation’s treasurer told the Post they didn’t know about the charity’s errors until March 21, when they learned of CREW’s complaint, and said there was no intent to deceive the IRS. Tax Analysts’ attempts to reach the Trump Foundation and Trump’s representatives, along with Bondi’s spokesperson, were unsuccessful.

However, Whitney Ray, Bondi’s director of media relations, told The Wall Street Journal in a statement that no state joined New York’s lawsuit regarding Trump University and that after receiving one complaint, the Florida attorney general’s Citizens Services Office referred the complaining party to the New York attorney general’s office, since New York’s lawsuit sought relief for consumers across the country.

In a February 1 news analysis, David Cay Johnston wrote that Trump has “clearly used the charitable foundation under his control to further his campaign for the White House,” but said that may not be illegal. Congress should hold hearings to clarify the law, Johnston wrote.

Fred Stokeld contributed to this article.

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The 21st Century Fight Over Who Sets the Terms of the Charity Property Tax Exemption

by Evelyn Brody

Evelyn Brody, Professor at Chicago-Kent College of Law, Illinois Institute of Technology, and Associated Scholar, the Urban Institute Center on Nonprofits and Philanthropy. I am grateful to Harvey Dale and Jill Manny’s invitation to prepare this article for “Elasticity of the Boundaries: What Is (and Isn’t) Charitable?,” Annual Conference of the National Center on Philanthropy and the Law, New York University School of Law (New York, Oct. 29-30, 2015). I thank the NCPL conference participants, especially my discussants, Sean Delany and Jonathan Small, and subsequent suggestions from David Thompson and Betsy Schmidt. I appreciate additional support from the Urban Institute’s Tax Policy and Charities Project, funded by the Bill and Melinda Gates Foundation and the Charles Stewart Mott Foundation. All views expressed here are mine. Along with a title change prompted by the NCPL discussion, this version is updated to March 20, 2016.

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In the “Why us?” department, nonprofits can be forgiven for fretting about the constant — and seemingly increasing — attention to property tax exemption for charities. After all, the term “tax-exempt property” makes it sound like the eds, meds, and churches are massive leeches on local property tax payers, but the lion’s share of exempt property is owned by governments. Moreover, states have always offered exemptions and other subsidies to encourage business creation (or entice businesses to relocate). Individuals, too, whether as homeowners, low-income persons, veterans, or the elderly, enjoy an array of tax abatements, credits, and caps. Accordingly, the property tax has always been more properly viewed as a question of “Who pays?” rather than “Who is exempt?”

Staying off the rolls or minimizing the tax bite often results from compromise — whether at the state constitutional level, in state statutes, as a matter of assessment, or through negotiation with local governmental bodies. Such an application of a multilevel framework for mischief leads to legal incoherence. This article examines developments in the nonprofit property tax exemption since the last piece I published on the subject, in 2010.

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3AHS Hospital Corp. v. Town of Morristown, 28 N.J. Tax 456, 479 (NJ Tax Court 2015) (emphasis in original). As to the hospital’s historical assertion, the court concludes, at 20: “The court rejects the Hospital’s contentions.” See discussion in Part III.A.


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We begin by examining a knockdown, drag-out separation-of-powers fight that has arisen in Illinois and Pennsylvania: Which branch, the judicial or legislative, defines “charities” granted exemption by the state constitution?

Next we turn to the more mundane world of statutory interpretation, where even here we find courts second-guessing the legislature. A June 2015 decision by the New Jersey tax court exemplifies what I view as “passive-aggressive separation of powers,” when the court basically says, “Surely the legislature could not have meant this entity (or this use of property) to qualify as charity.” This latest decision not only seemed to render all “sophisticated centers of medical care” in New Jersey taxable, but also is causing sleepless nights for Princeton University: The same judge has allowed a challenge to the university’s exemption brought by local taxpayers to go forward.

New Jersey’s January 2016 proposed legislation—which fell a pocket veto short of enactment—to impose a formula community-service fee on nonprofit hospitals suggests that a third-way solution might become more common. To set up the discussion, I describe disputes—which occasionally raise federal constitutional Commerce Clause concerns—over the requirement that an exempt charity “reduce the burdens of government.” Some legislatures, courts, and administrative agencies ask, “which government”?

Attempts to tailor exemption to benefits to local taxing jurisdictions lead to our final topic, payments in lieu of taxes (PILOTs). Examples are literally all over the map, from Boston’s revamped comprehensive PILOT program to a Florida appellate court’s striking of a PILOT program as inconsistent with statutory exemption. Will the people’s branch get the last word after all?

In keeping with the episodic—if not anecdotal—feature of a state-by-state tax regime, the paper concludes with an appendix, alphabetized by state, summarizing some other notable developments.7

I. Separation of Powers Between Courts and Legislature: Which Branch Construes the State Constitution?

Almost half of the state constitutions provide property tax exemption for classes of nonprofits—notably, churches, educational institutions, and “institutions of purely public charity” (or some similar term).8 In some states the high court has adopted a multifactor test (without specifying how the factors weigh and whether any is an absolute requirement). These tests typically call for the property owner to demonstrate that it and its use of the property: (1) benefit the general welfare of an indefinite number of persons, and render gratuitously a substantial portion of its services; (2) do not result in private benefit or profit; (3) operate with funds deriving mainly from donations; (4) reduce the burdens of government; and (5) result in charity dispensed to all who need and apply for it. These factors—particularly those requiring some level of donative support and gratuitous expenditure, absence of profit, and reducing governmental burdens—are themselves so ambiguous, broad, and overlapping that going to court still is often required, differing consequences across the states.

What if the legislature’s views of the constitutional term “charity” or “charitable use” differ from the court’s? State high courts vary on the degree of vigilance with which they assert their authority over constitutional terminology.9 I recently compared,10 in their construction of similar state constitutional language, the absolutist approach of the Illinois Supreme Court11 with the apparent deference in Minnesota to a legislative compromise.12 In 2012, echoing Illinois, the Pennsylvania Supreme Court declared that the legislature could curtail, but not enlarge, the Court’s definition of the constitutional term “institution of purely public charity.”13 In states like Illinois and Pennsylvania, real clarity or change requires an amendment to the state constitution.

8As described in the appendix to Brody (2010), supra note 6, 17 state constitutions mandate exemption for charities (variously termed); 25 state constitutions grant the legislature authority to exempt charities; and eight state constitutions (and the U.S. Constitution, with respect to the District of Columbia) are silent on taxes or exemption.

9For example, Tennessee courts have recognized that “the Tennessee Constitution does not define the term ‘charitable.’ This fact necessarily allows the Legislature some discretion in determining the meaning of the term.” Club Sys. of Tenn., Inc. v. YMCA of Middle Tenn., 2005 Tenn. App. LEXIS 793 (Dec. 19, 2005).

10Brody (2010), supra note 6.

11See Provena Covenant Med. Center v. Dep’t of Revenue, 925 N.E.2d 1131 (Ill. 2010), discussed in the text below.

12In Under the Rainbow Child Care Center Inc. v. County of Goodhue, 741 N.W.2d 880, 886 (Minn. 2007), the Minnesota Supreme Court ruled that the “factor three inquiry” — “the extent to which the recipients of the charity are required to pay for the assistance received” — is not merely to be taken into account, but rather “tests for a value that is fundamental to the concept of charity — that is, whether the organization gives anything away” (emphasis in original). While “not contract[ing] or expand[ing] the definition,” Minn. Stats. section 272.02(7)(a), as amended in 2009, requires charities to meet all six judicially created factors, with factors (1), (4), and (6) being mandatory, and factors (2), (3), and (5) allowing a “reasonable justification” exception.

A. Illinois

The modern Illinois dispute begins with Provena Covenant Medical Center (now Presence Covenant). The appellate court had issued a strong opinion upholding revocation of Provena’s exemption because, in large part, it provided a minuscule percentage of charity care. In the Supreme Court deliberations, two of the seven justices recused themselves. While the five remaining justices agreed that Provena was not entitled to property tax exemption for the year at issue, the two concurring justices focused on proof problems and dissented from the plurality’s asserted charity care standard. Failing to obtain an absolute majority of four justices, the standard propounded in the plurality opinion is nonprecedential.14

On the separation-of-powers issue, the Provena plurality declared: “The legislature cannot add to or broaden the exemptions specified in section 6 [of the Illinois Constitution].”15 The other two justices took a different view of the court’s role: “The legislature did not set forth a monetary threshold for evaluating charitable use. We may not annex new provisions or add conditions to the language of a statute.”16 Their opinion explained: “Setting a monetary or quantum standard is a complex decision which should be left to our legislature, should it so choose. The plurality has set a quantum of care requirement and monetary requirement without any guidelines. This can only cause confusion, speculation, and uncertainty for everyone: institutions, taxing bodies, and the courts.”17

Subsequent Illinois budget negotiations demonstrate that charities enjoy political support. In 2011 the governor responded to the Revenue Department’s revocation of several nonprofit hospitals’ exemptions with a moratorium, pending negotiation over a legislative solution.18 Interestingly, the hospitals accepted the state’s “quid pro quo” view of exemption,19 and focused their efforts on assuring a broad definition of community benefit. At the end of May 2011, the legislature passed provisions that

“establish quantifiable standards for the issuance of charitable exemptions for such property” and dispel the “considerable uncertainty surrounding the test for charitable property tax exemption, especially regarding the application of a quantitative or monetary threshold.”20 The broad statutory definition of community benefit includes not just charity care but also, for example, Medicaid shortfalls and unreimbursed costs of providing or subsidizing goods, activities or services addressing the health of low-income or underserved individuals; services relieving the burden of government related to healthcare for low-income individuals; and “providing medical education; and conducting medical research or training of health care professionals.”21

In an apparently unprecedented feature designed to protect hospitals from charges of unfair competition, the legislation also provides an income tax credit for investor-owned hospitals equal to the lesser of the cost of charity care they provide or the property tax they pay.22 It will be interesting to see the data, when available, on investor-owned hospitals’ income tax credits for community benefit provided. If nonprofit hospitals find, as expected, that the broad definition of community benefit they enjoy outweighs the value of their property tax exemption, the new statute might actually cost the state revenue!

The Illinois governor’s letter (as quoted in footnote 18 above), acknowledged a concern with constitutional constraints. In litigation over a hospital’s exemption, the Illinois courts, as described above, could determine that the legislative efforts fail to satisfy the judicially defined constitutional term “charity.” As a separate matter, charities other than hospitals are not addressed in the new statute — so does the state’s quid pro quo conception of exemption apply to them too? (Do churches and educational institutions need not worry about this because they fall under exemptions specifically named in the constitution?) If non-hospital charities must demonstrate a quid pro quo, do they enjoy a broad definition of community benefit, as do hospitals under the statute? Or does some narrower conception, such as the quantum of charity care, apply? Ominously, in 2011, an Illinois appellate court denying exemption to a retirement home commented (in an unpublished opinion): “The amount of

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14 See John D. Colombo, “Provena Covenant: The (Sort of) Final Chapter,” Exempt Org. Tax Rev. 489 (May 2010) (quoting the concurring justices’ observation, “the discussion of charitable use does not command a majority of the court and, therefore, is not binding under the doctrine of stare decisis”).
15 Provena, 925 N.E.2d at 1145. The plurality cited an earlier state Supreme Court case rejecting property tax exemption for the Chicago Bar Association on the ground that only the courts, and not the legislature, may determine whether particular property is used “exclusively for ***school ***purposes” within the meaning of the constitution.
16 Id. at 1157 (Burke, J., concurring and dissenting).
17 Id. at 1159.
18 See letter from Gov. Pat Quinn to Illinois Hospital Association president (Sept. 19, 2011), announcing moratorium on Department of Revenue hospital revocations until March 1, 2012, to allow the state and private stakeholders to develop recommendations for legislation “that is fair to both hospitals and taxpayers and meets the requirements of the Illinois Constitution,” at http://www.ihatoday.org/uploadDocs/1/govltrtaxexemption.pdf.
21 Id., subsection (e).
22 Illinois Income Tax Code section 223(a) (35 IILCS 5/223) (“a taxpayer that is the owner of a hospital licensed under the Hospital Licensing Act, but not including an organization that is exempt from federal income taxes under the Internal Revenue Code, is entitled to a credit against the taxes imposed under subsections (a) and (b) of Section 201 of this Act in an amount equal to the lesser of the amount of real property taxes paid during the tax year on real property used for hospital purposes during the prior tax year or the cost of free or discounted services provided during the tax year pursuant to the hospital’s charitable financial assistance policy, measured at cost”).
charity that it dispenses, $30,000, is far less than the property tax it would pay in the absence of an exemption, $160,501.43.\textsuperscript{23}

Urbana has continued to fret over the property tax exemption of two major hospitals it hosts, Presence (née Provena) Covenant and Carle Hospital.\textsuperscript{24} Urbana spurned — as an attempted “bribe,” according to its mayor — Carle’s checks for $100,000 to cover costs of police and fire protection.\textsuperscript{25} In early January 2016, accepting arguments made by the government defendants in Carle’s bid for exemption, an appellate court held the new statute unconstitutional.\textsuperscript{26} Remember that property tax exemption is different from income tax exemption: It’s not enough for the property owner to be a charity; it also has to use the subject property for a charitable purpose. The court declared: “Under section 15-86, a tax exemption is different from income tax exemption: the whole thing,” Prussing said. “You don’t get to pick and choose what taxes you pay for. When you don’t get a tax bill, that’s your share, and you’re supposed to pay for the whole thing,” Prussing said.\textsuperscript{27}

Accordingly, the court held:

\textsuperscript{23}Meridian Vill. Ass’n v. Hamer, 2011 Ill. App. Unpub. LEXIS 222. For analysis of charity care provided by nonprofit hospitals in other states, compare Erica Valdivinos, Sidney Le, and Renee Y. Hsia, “In California, Not-For-Profit Hospitals Spent More Operating Expenses on Charity Care Than For-Profit Hospitals Spent,” 34 Health Aff. 1296 (August 2015), abstract available at http://content.healthaffairs.org/content/34/8/1296.abstract ("Using data from California, we examined whether the levels of charity and uncompensated care provided differed across general acute care hospitals by profit status and other characteristics during 2011-13. The mean proportion of total operating expenses spent on charity care differed significantly between not-for-profit (1.9 percent) and for-profit hospitals (1.4 percent), in contrast to the mean proportion spent on uncompensated care."); with Frances A. Kennedy, Laurie L. Burney, Jennifer L. Troyer, and J. Caleb Stroup, “Do Non-Profit Hospitals Provide More Charity Care When Faced With a Mandatory Minimum Standard? Evidence From Texas,” 29 J. Acc’g & Pub. Pol’y. 242 (2010), abstract at http://www.sciencedirect.com/science/article/pii/S0278425409000921?via=ihub (analyzing a 1993 Texas statute requiring tax-exempt hospitals to spend a minimum of 4 percent of net patient revenue on charity care, a requirement modified in 1995 to allow a deduction for bad debts; finding that “hospitals with higher total margins decreased charity care spending, an unintended consequence of the legislation” and observing that “[s]eventeen states have followed Texas’ lead by enacting legislation regarding the charity care spending by NFPs.")

\textsuperscript{24}At the 2015 NCPL conference, participant John Colombo explained that Champaign, Illinois, has been free riding on the costs of exemption borne by its twin city, Urbana, which hosts both Carle and Provena.

\textsuperscript{25}Urban Rejects Over $100,000 From Carle Foundation Hospital,” Daily Illini: University of Illinois at Urbana — Champaign, Nov. 20, 2014. The story quoted Urbana’s mayor: “You don’t get to pick and choose what taxes you pay for. When you get a tax bill, that’s your share, and you’re supposed to pay for the whole thing,” Prussing said.


\textsuperscript{27}Slip op. at para. 142 (citations omitted). If the legislature wished, it could provide that even though property is used exclusively for charitable purposes, the property shall be exempt from taxation only if, additionally, the value of the charitable services equals or exceeds the estimated property tax liability — because, again, the legislature is free to make the terms of an exemption more restrictive than the terms in article IX, section 6 (Provena, 384 Ill. App. 3d at 741). But the legislature lacks the constitutional authority to provide that, regardless of whether the property is used exclusively for charitable purposes, the property shall receive an exemption if the value of the charitable services equals or exceeds the estimated property tax liability — because that would be adding to or broadening the exemption in article IX, section 6 (see id.).\textsuperscript{28}

Because a state statute was ruled unconstitutional, the Illinois Supreme Court would have to accept Carle’s February 2016 appeal. In the meantime, Carle faces the prospect of paying $6.5 million in property tax a year, and the Department of Revenue has to decide what to do with five pending exemption applications, to say nothing of those already under review.\textsuperscript{29}

B. Pennsylvania

The 2012 Pennsylvania case involved a 61-acre summer camp run by an orthodox Jewish nonprofit. The intermediary Commonwealth Court had found that the camp failed to meet the judicially established factor of reducing the burdens of government — a factor that the camp argued it satisfied under the legislative definition. The Pennsylvania Supreme Court refused to weigh in on the merits of the case, limiting the appeal to the sole question of the validity of the Court’s multifactor test for exemption, propounded in Hospital Utilization Project (the HUP test).\textsuperscript{30} Four of the seven justices held: “our prior

\textsuperscript{28}Slip op. at para. 155 (emphases in original).

\textsuperscript{29}See Lisa Schnecker, “Ruling Throws Illinois Hospitals’ Tax Exemptions Into Question,” Modern Healthcare, Jan. 7, 2016 (“the city has lost 11 percent of its assessed tax value since Carle was relieved of paying $6.5 million a year in property taxes — the vast majority of which went to Urbana and its school district”), at www.modernhealthcare.com/article/20160107/NEWS/3122596999.

\textsuperscript{30}See two subsequent Commonwealth Court cases denying exemption for failure to satisfy one of the HUP factors: Camp Hachshara Moshava of New York v. Wayne County Board for the Assessment and Revision of Taxes, 47 A.3d 1271 (Pa. Commw. 2012) (religious summer camp does not lessen the burdens of government); In re Appeal of Dunwoody Vill., 52 A.3d 408 (Pa. Commw. 2012) (continuing care retirement; community meets none of the HUP factors; note, in particular, the holding that “given that a substantial percentage of DVI’s officers and executives’ compensation is based on DVI’s financial or market-place performance, . . . DVI failed to establish that it operates entirely free from private profit motive”). In writing about this latter case, Philadelphia nonprofit legal authority Don Kramer comments: “This is another example of how Pennsylvania’s common law cases fail to set out specific benchmarks for meeting the five-prong test and the language of the case law is so inconsistent that both sides can cite language to support their (Footnote continued on next page.)
jurisprudence sets the constitutional minimum for exemption from taxes; the legislation may codify what is intended to be exempted, but it cannot lessen the constitutional minimums by broadening the definition of ‘purely public charity’ in the statute.’’31

While the majority declared that ‘‘our courts will apply the [HLIP] test in light of evolving circumstances,’’ the three-justice dissent observed that the majority failed to explain how changes to that test may occur. Rather, the dissent asserted, ‘‘so long as the statute otherwise comports with the Constitution, . . . the catalyst for such alterations in the constitutional standards can only be found in a function served by the Legislature — monitoring policies as they shift with societal changes.’’ After all, courts must wait for disputes between two opposing parties to arise, and so the judiciary cannot systematically and proactively effect a nuanced solution to societal change. Indeed, the very statute at issue, Act 55 (1997), resulted from a years-long negotiation among all parties. In that compromise, the nonprofits agreed that for-profit competitors would have standing to complain in court about a given nonprofit’s property tax exemption. If the definition of ‘‘institution of purely public charity’’ cannot be determined by the legislature, what happens to those standing rights?

The Pennsylvania nonprofit sector fears that this decision shifts the balance of power — or, at the least, the likelihood of PILOT ‘‘requests’’ — to the municipalities. It did not take long for the sector to find help back in the statehouse. An amendment to the Pennsylvania constitution requires the approval of the House and the Senate two years in a row, as well as approval by the electorate. In June 2013, the Pennsylvania legislature approved by joint resolution an amendment that would authorize the legislature to determine the qualifications for exemption for institutions of purely public charity; in the next two-year session, the legislative votes took place in 2015.32 But progress was not smooth, and there is concern that the legislature’s proposal to amend the state constitution — still to be ratified by referendum — will not work.

Storm clouds had appeared in December 2014, when the state’s auditor general reported $1.5 billion in lost tax revenue on account of charities located in the 10 counties experiencing debate over their exemptions.33 In February 2015 the Republican-controlled Senate passed the proposed constitutional amendment on a 30-19 party-line vote.34 Even though the House was also Republican-controlled, action stalled. The bill was referred to the House Finance Committee, whose chair (supported by some of the committee’s Democratic members) announced public hearings. Approval by early August would allow for the proposal to appear on the November ballot. According to one press report: ‘‘Lobbyists engaged on the issue said that amendment proponents — including tax-exempt hospitals — appear to be weighing whether to push for a referendum in November’s off-year ballooning versus in next year’s high-turnout presidential election.’’35

Moreover, legislators and others are expressing uncertainty over the legal consequences of the proposal. A news story commented: ‘‘The problem, as the House weighs whether to put the amendment before voters, is that no one really knows whether its approval would prompt a wholesale review of the rules. Some legislators contend it would merely revive rules made two decades ago, or spur a court fight. . . . [The latter] would be ironic, since the 28-word amendment aims to reduce the role of courts in deciding questions of tax exemption.’’36

Separately, on June 29, 2015, Senate Resolution 28, ‘‘A Concurrent Resolution establishing the Joint Select Committee on Institutions of Purely Public Charity . . . to examine, investigate and complete a study of the laws of this Commonwealth regarding tax exemptions provided to institutions of purely public charity,’’ was referred to the House Committee on Finance.37 No action occurred in 2015 on the proposal to amend the Pennsylvania constitution.

C. The Constitutional Way Forward?

The approach of the Illinois and Pennsylvania Supreme Courts means that court-imposed definitions of charitable use can be expanded in those states only through a constitutional amendment process. This approach creates several problems.

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31 Mesivtah Eitz Chain of Bobov Inc., supra note 13.


First, unless the courts are flexible, this view of constitutional supremacy locks in definitions of charity that often do not account for societal changes. Indeed, the modern nonprofit hospital looks nothing like the standalone community hospital of the 1960s. While that does not necessarily mean that exemption standards should change to accommodate the evolution of these organizations, it does mean that one of the traditional roles of the legislature — adjusting the law to account for societal changes — cannot be applied to definitions of charity for property tax exemption purposes. The 2015 New Jersey tax court’s invitation to the legislature in denying exemption to Morristown Medical Center (discussed in Part III.A., below) provides an interesting contrast: “If the property tax exemption for modern non-profit hospitals is to exist at all in New Jersey going forward, then it is a function of the legislature and not the court to promulgate what the terms and conditions will be. Clearly, the operation and function of modern non-profit hospitals do not meet the current criteria for property tax exemption under . . . applicable case law.”

Second, while disputes over the validity of legislative solutions are being litigated, gaps persist, leaving taxpayers and local taxing jurisdictions dealing with continual uncertainty. (The justices in the minority in both the Illinois Provena case and the Pennsylvania Camp Hachshara case recognized the difficulties that would ensue with a hamstrung legislature.) Indeed, when the Illinois legislation was being worked out, the Civic Federation had suggested that the only definitive way forward would be to amend the state constitution.

Although the doctrine of separation of powers offers an important balance in a constitutional system, state supreme courts should reflect on the downside of too narrowly construing legislative authority regarding charitable property tax exemptions. Recognizing that the legislature has a significant role to play in the evolution of the definition of charity is not capitulation to the legislative branch but rather a pragmatic acknowledgement that litigation is an unsatisfactory way to resolve public policy differences, particularly when it is a question of public finance and more particularly when concepts as vague as “charity” are involved.

D. Applying Standards for Property-Tax Exemption for Charities

Meanwhile in New Jersey, all eyes have been focused on Princeton University’s efforts to fight off a challenge to its tax exemption. As explained by the New Jersey Center for Non-Profits:

In Fields v. Trustees of Princeton University, a case attracting national attention, four Princeton residents are seeking to revoke the entire property tax exemption of Princeton University based on a far-reaching set of grounds, including the University’s investments, the payment of patent royalties to some of its faculty in accordance with federal statute, and some fee-based operations such as cafés.

Since 2001 New Jersey law has provided for a prorated property tax exemption structure under which a property owned by a charitable organization that is used for mixed purposes, both charitable and non-charitable, is only subject to tax on the non-charitable portion. Yet the plaintiffs in the Princeton case are seeking to revoke the University’s property tax exemption in its entirety based on allegations surrounding some of the University’s properties, without regard to their proportion in relation to the University’s mission or other exempt functions. Unlike many of the other property tax challenges across the nation, in this case the municipality is named as a codefendant.

According to one press report on Tax Court Judge Vito Bianco’s decision to allow the case to proceed: “Public interest lawyer Bruce Afran, who represents a handful of Princeton residents in the case, said yesterday . . . ‘This is the first time this type of challenge has been filed in any state.”’

Note that because of the direct injury, a taxpayer may more easily challenge property tax exemption than meet the requirements for standing under federal jurisprudence.

It seems preposterous that Princeton University has been unable to shake this challenge from a private litigant charging that high levels of income from royalties, some shared with faculty, converts the institution into a commercial enterprise precluded from the charitable property tax exemption. (In 2014 the town, which has no beef with the university, entered into a seven-year, $21.7 million PILOT agreement. The plaintiff’s attorney, . . .

39AHS Hospital Corp., supra note 3.

38In its recommendations for legislative action, the Civic Federation cautioned: “To eliminate any possible uncertainty as to whether the General Assembly lacks plenary authority to define clear legislative standards of eligibility because of judicial decisions limiting ‘charitable use’ under . . . the Illinois Constitution to criteria defined by the courts, the Civic Federation recommends that, longer term, a constitutional amendment be proposed to confirm such authority in the General Assembly.” Civic Federation Position Statement on Charitable Property Tax Exemptions for Non-Profit Hospitals (Chicago, Feb. 27, 2012), at http://www.civicfed.org/civic-federation/publications/position-statement-charitable-property-tax-exemptions.

40Go to http://www.njnonprofits.org/AmicusBriefFiled_PrincetonU.html; see also http://www.njnonprofits.org/PropertyTaxExemption.html.

41Jon Offredo, “Lawsuit Challenging Princeton University’s Tax-Exempt Status Won’t Be Dismissed,” Times of Trenton, June 29, 2013. This article’s subheading reads: “The school’s policy of sharing patent royalties with faculty could cost the university an additional $20 to 30 million in taxes a year.”

42Nicole Mulvaney, “Princeton Council Votes to Accept 7-year, $21.7 Million Deal with Princeton University,” Times of Trenton, Apr. 28, 2014 (“The university will also make five additional payments for municipal projects that serve the university’s interests as well as the town’s, such as $500,000 for construction of a new Princeton First Aid and Rescue Squad (Footnote continued on next page.)
however, told town residents that their property taxes
would fall by a third if Princeton University were tax-

able. 43 Granted, property tax exemption does not neces-
sarily track the federal regime, but does anyone really
think Princeton is going to lose exemption on this

ground?

But the Princeton case is a distraction to the real action
in New Jersey. 44 At the end of June, the same judge,

essentially ended property tax exemption for most, if not
all, nonprofit hospitals in New Jersey in upholding the

municipality’s denial of exemption for Morristown Medi-
cal Center. 46 (The named party is the corporate parent,

Atlantic Health System (AHS).)

In Morristown, Judge Bianco’s observations brought
back memories of the U.S. House Ways and Means

Oversight Subcommittee hearings on the unrelated busi-
ness income tax, where Chairman Jake Pickle, D-Texas,
expressed alarm that the corporate chart of a modern

hospital system demonstrated uncharitable “empire

building.” Judge Bianco declared:

Non-profit hospitals have changed significantly,

however, from their early origins as charitable alms

houses providing free basic medical treatment to the

infirm poor. Today they are sophisticated cen-

ters of medical care, and in some cases, education,

providing a litany of medical services regardless of

a patient’s ability to pay.

Recently, New Jersey has experienced the emerg-
ence of tax-paying, for-profit hospitals now compet-

ing for the same pool of medical professionals and

patients as their non-profit forebears. Like their

new for-profit competitors, today’s non-profit hos-

pitals have evolved into labyrinthine corporate

structures, intertwined with both non-profit and

for-profit subsidiaries and unaffiliated corporate en-
tities. 48

Later in his opinion, he stated: “despite this evolu-
tion, hospitals continued to benefit from tax exemptions
due to their long tradition of providing free charitable
care for those in need . . . . As American hospitals have
evolved from their charitable origins dating to the mid-
18th century, so too have our laws granting tax exemp-
tions to hospitals, originally as charitable institutions for
charitable purposes, and later as associations or corpora-
tions for hospital purposes.”

The activities of for-profit physicians on the premises

doomed Morristown’s claim for exemption, the court
explained: “Of the three types of physicians that provide
care at the subject property, voluntary physicians and

exclusive contract physicians (i.e. RAP doctors) are pri-

cate, for-profit doctors that are not employed by the

Atlantic healthcare system.” Because these physicians are

taxable, the court sought to “determine where these

physicians practice on the Subject Property” and “where

these physicians do not practice on the Subject Property
in order to identify the areas of the Hospital where exemp-
tion may be preserved.” However, it “became clear that

employed physicians, voluntary physicians, and RAP
doctors were not contained within any particular area of
the Subject Property. In fact, they all worked throughout
the Subject Property without limitation or restriction.”
Moreover, the court expressed alarm that these physi-

cians “not only operate throughout the Hospital, but they
use the Hospital facility to generate private medical bills
to patients. These bills are charged directly by the private
physicians to the patients, and all the money goes
directly to the physicians.” 50 The court concluded: “as-
suming that for-profit hospitals have the same kinds of
arrangements with for-profit doctors as here, . . . the
Hospital is asking the court to embrace an interpretation
of N.J.S.A. 54:4-3.6 that would result in an inequitable
advantage to non-profit hospitals over for-profit hospi-

tals.”

Separately, Judge Bianco held that the hospital’s rela-
tionships with for-profit affiliates precludes exemption:

By entangling its activities and operations with
those of for-profit entities, the Hospital allowed its
property to be used for profit. This confluence of
effort and activities with for-profit entities was
significant, and a substantial benefit was conferred
upon for-profit entities as a result. Accordingly, the
Hospital failed to satisfy the profit test as set forth
in Paper Mill Playhouse, and is precluded from
exemption. 51

48 Id. at 465.
49 Id. at 484 (emphasis in original).
50 Id. at 501-502 (emphasis in original).
51 The court stated, id. at 513 (emphasis in original):
“The Hospital provided substantial subsidies to various
related and unrelated for-profits in the form of working capital
(Footnote continued on next page.)
As to executive compensation, even though the hospital’s board followed the practices under the federal rebuttable presumption of reasonableness, the court refused to apply this presumption on the ground that the hospital’s expert failed to address whether “the hospitals he chose for the peer group in fact did the same thing.” The court added: “This is similar to why comparing assessments of different properties in a property tax appeal is disallowed — the other assessment may be incorrect.” The court concluded: “If the only consideration is what similar hospitals set as salaries, then the salaries would always be reasonable; a conclusion wholly self-serving to all non-profit hospitals.” The court was also critical of incentive compensation paid to staff physicians: “The incentive pools were derived from departmental expenses and the profit was split between the hospital and the employed physicians, indicating the operation was conducted for a profit-making purpose. Accordingly, the court finds that this incentive provision of the employed physicians’ contracts violates the profit test.”

Judge Bianco separately ruled that the managed services contract with Aramark (for food and the cafeteria, laundry, environmental, and patient transportation) also violated the profits test, and so “the corresponding areas of the Hospital where Aramark operates are subject to taxation.”

Finally, the court rejected exemption for the gift shop. The court, though, upheld exemption for the visitors’ parking garage, employee fitness center, and auditorium (but held that the claim for exemption for the employee daycare center failed for lack of proof).

In its concluding section, the opinion declared: “if the property tax exemption for modern non-profit hospitals is to exist at all in New Jersey going forward, then it is a function of the Legislature and not the courts to promulgate what the terms and conditions will be. Clearly, the operation and function of modern non-profit hospitals do not meet the current criteria for property tax exemption under N.J.S.A. 54:4-3.6 and the applicable case law.”

Morristown Medical Center’s vulnerabilities seem more typical than for Princeton University, in which the challenge comes from a taxpayer. Both cases, though, suggest saber rattling, a prelude to a negotiated financial arrangement. As to the immediate matter, Morristown and AHS Hospital Corp quickly reached a settlement, calling for the hospital to pay about $15.5 million in back taxes, interest, and penalties, plus tax on almost a quarter of its facility, estimated at $1.05 million a year, for the next 10 years.

But it didn’t take much longer for a legislative response. With the unanimous support of the New Jersey Hospital Association board, a year-end deal would have required all financially healthy hospitals in New Jersey to make annual “Community Service Contributions” payments. Proposed to take effect in January 2016, the new statute called for tax-exempt hospitals (but not government facilities) to pay $2.50 per day for each hospital bed in the prior year plus $250 per day (reduced in committee from the original proposal of $750) for any satellite emergency care facility. Unprofitable hospitals meet the requirements of the profit test as articulated in Paper Mill Playhouse, and therefore, the Visitors’ Parking Garage area is exempt from taxation.”

But it didn’t take much longer for a legislative response. With the unanimous support of the New Jersey Hospital Association board, a year-end deal would have required all financially healthy hospitals in New Jersey to make annual “Community Service Contributions” payments. Proposed to take effect in January 2016, the new statute called for tax-exempt hospitals (but not government facilities) to pay $2.50 per day for each hospital bed in the prior year plus $250 per day (reduced in committee from the original proposal of $750) for any satellite emergency care facility. Unprofitable hospitals meet the requirements of the profit test as articulated in Paper Mill Playhouse, and therefore, the Visitors’ Parking Garage area is exempt from taxation.”

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could have applied for an exemption. A statement prepared by the Assembly Appropriations Committee explained.62

As amended, this bill maintains the property tax-exempt status of a nonprofit hospital with for-profit medical providers on site . . . , and requires non-profit hospitals to, in lieu of property taxes, pay an annual community service contribution to their host municipalities. The . . . community service contributions are required to be used to offset the costs of public safety services, such as police and fire safety services, or to reduce the property tax levy. Any voluntary payments made by a nonprofit hospital for the same purpose of offsetting public safety costs will count towards the obligation. . . .

The bill’s legislative fiscal estimate determined community service contributions from exempt hospitals would total almost $211 million in the first year.63 The Office of Legislative Services added: “Total collections will be affected by the effect of other voluntary contributions made by owners of nonprofit hospitals to municipalities on community service contribution liabilities, and whether any owner receives an exemption from payment for a particular tax year” — while noting that “[i]nformation on the total amount of voluntary contributions made by the owners of nonprofit hospitals is not available at this time.”

Despite the opposition of the New Jersey League of Municipalities,64 the state Senate and Assembly passed the bill on January 11, 2016, the last day of the legislative session, but the bill was allowed to lapse by the governor.65 With 15 nonprofit hospitals appealing tax bills, on March 18, 2016 Governor Christie announced a two-year moratorium to give a newly appointed commission time to find a solution, but that controversial route requires legislative enactment. 66

The implications of the Morristown decision for other types of nonprofits await a separate legislative solution — if any.66 Ominously, in November 2015, Judge Bianco denied Princeton University’s motion that the burden of proof should shift from it, the claimant for exemption, to the plaintiffs challenging the exemption.68

II. Reducing the Burdens of Which Government?

“Government” not being a monolith, a “quid pro quo” theory of property tax exemption raises interesting constitutional and interpretive questions of fit between the jurisdiction bearing the cost of exemption and the population served by the would-be exempt charity.

A. Out-of-State Beneficiaries and the Commerce Clause

States on occasion try to limit favorable tax treatment to charities that serve only in-state residents.69 The issue has arisen under both the property tax regime and the income tax regime, with respect to the charitable contribution deduction.

One would have thought the U.S. Supreme Court’s decision in Camps Newfound/Owatonna would preclude attempts to deny tax exemption or deductibility to charities that benefit those beyond state borders.70 And indeed the few subsequent statutory or administrative proposals taking this position, when challenged, have died the death they deserve.


62See N.J. Assembly Appropriations Committee, Statement to A4903 with committee amendments, Jan. 7, 2016 at http://www.njleg.state.nj.us/2014/Bills/A5000/4903_S1.HTM.

63Legislative Fiscal Estimate, S3299, State of New Jersey, 216th Legislature (Dec. 24, 2015), available at http://www.njleg.state.nj.us/2014/Bills/S3500/3299_E1.HTM. The municipalities would be required to remit 5 percent of this amount to the appropriate county governments.

64N.J. League of Municipalities, Weekly Policy Update, Jan. 8, 2016, at http://www.njslom.org/letters/2016-0108-weekly-update.html (“[By exempting] all acute care hospital properties owned by non-profits incorporated in New Jersey [], the bill] also extends that exemption to any for-profit medical service activity which takes place on that property. In effect, non-profits that act as real-estate holding companies will provide a property tax exemption benefit for the for-profit activities which take place on their properties”).


66See Susan K. Livio, “Christie Pushes for 2-Year ‘Freeze’ on Taxing Hospitals,” NJ Advance Media for NJ.com, Mar. 18, 2016, at (Footnote continued in next column.)
California charities suffered a scare in 2011. Efforts by attorney Ofer Lion and others moderated an attempt by the Board of Equalization to construe California’s “welfare exemption” as requiring a nonprofit to “primarily benefit persons within the geographical boundaries of the State of California.” Lion explained: “The Board’s geographically-based benefit requirement for qualification under the welfare exemption is known as the ‘community benefit test.’” He reported: “The 2011 Letter (1) in no event . . . is the community benefit test applied on a strict mathematical basis with a threshold over which the test is met (e.g., 50 percent or more of the activities must benefit the California community) and under which the test fails.” However, the BOE’s website in June 2015 shows that the agency continues to require benefit to Californians.

In the online file of memos leading up to the BOE’s 2008 directive, the revenue estimate assumes that current practice has been to follow the narrower view of eligibility, and so the estimate is of how much revenue would be lost if the board adopted the broader view. To what extent do we know if this was actually the case, or did assessors just give charities their exemption without regard to where the community benefit fell?

Note that a similar issue arose in the Pennsylvania summer camp case described above. That court, however, dodged the issue by describing the issue as outside its grant of review.

A similar constitutional dispute recently was also avoided in Vermont. The end of the 2015 budget process in Vermont brought a sigh of relief to taxpayers seeking to deduct their charitable contributions under the state income tax. Under the version passed by the state Senate, deductible donations would have been defined as those made to charities located in (or near) Vermont and found to primarily benefit persons within the geographical boundaries of the State of California.


74California State Board of Equalization, Letter to Assessors, No. 2011/044 (Dec. 7, 2011), http://www.boe.ca.gov/proptaxes/pdf/lta11044.pdf, clarifying the “use of the term ‘primarily’ in the administration and application of the community benefit test to a charitable organization’s claimed charitable activities for purposes of the welfare exemption.” The guidance concludes: “Even in situations where quantification of charitable activities benefitting the California community is possible, all facts and circumstances are considered to determine whether the test is met even in situations where the California community receives only a small percentage of benefit from the charitable activities. As currently applied by staff, the community benefit test is met if all of the facts and circumstances demonstrate that the charitable activities performed by the nonprofit organization confer some ‘meaningful,’ ‘important,’ or ‘significant’ benefit to persons within the geographic boundaries of the State of California.” See also California State Board of Equalization, Property Tax Welfare Exemption (Publication 149 March 2008), available at http://www.boe.ca.gov/proptaxes/pdf/pub149.pdf, and Memorandum from the CSBOE, “Property and Special Taxes Department, to County Assessors, Community Benefit Test For The Welfare Exemption” (No. 2008/034, May 2, 2008), available at http://www.boe.ca.gov/proptaxes/pdf/lta08034.pdf. Background documents and timeline are maintained at http://www.boe.ca.gov/proptaxes/welfarebenefit_test.htm.

75This and other documents and timeline are maintained at www.boe.ca.gov/proptaxes/welfarebenefit_test.htm. See also FAQ 11 at http://www.boe.ca.gov/proptaxes/faqs/welfarebenefit_test.htm, which concludes: “The charitable activities must be...
serving Vermonters. The National Council of Nonprofits commented that such a provision “would no longer permit tax deductions for donations to international efforts, even relief related to the Nepal earthquake.”

A similar parochial provision had been voided by the Minnesota Supreme Court, which cited *Camps Newfound/Owatonna* to strike down a state alternative minimum tax deduction allowed only for contributions made to charities that serve Minnesota residents. The plaintiff had made a lump sum contribution to a donor-advised fund established by the Fidelity Charitable Gift Fund in Boston and had argued that future distributions would be made only to Minnesota charities. The Minnesota Supreme Court remanded for a determination of remedy: expanding or eliminating the Minnesota AMT deduction so that it applied equally to all charitable donations. In the meantime, the Minnesota Legislature chose the former remedy.

But parochial attempts to limit exemption continue. In April 2015 the Wyoming Department of Revenue issued final regulations setting forth standards for property tax exemption. With respect to schools, orphan asylums, and hospitals, the regulation provides in part: “(a) The fundamental basis for this exemption is the benefit conferred upon the public by schools, orphan asylums and hospitals, and the consequent relief, to some extent, of the burden upon the state to educate, care and advance the interests of its citizens. Such institutions thus confer a benefit upon the general citizenry of the state and render an essential service for which they are relieved of certain burdens of taxation.” Paragraph (e) states: “If a school, orphan asylum or hospital confers benefit only upon the citizens of another state, its property is not exempt.” Similarly, the regulation dealing with “charitable societies or associations” declares at the end of paragraph (a): “The fundamental basis for this exemption is the benefit conferred upon the public, and the consequent relief, to some extent, of the burden upon the state to care and advance the interest of its citizens.” Paragraph (c) provides: “The property must be used directly for the operation of the charity, which would directly benefit the people of this state.”

### B. Intrastate Taxing Jurisdictions: War Within the States

Municipalities and other local taxing jurisdictions suffer under a structure in which exemption is decided at the state level, but the burden is felt within the borders of the localities. Because the population served by exempt charities often extends more broadly, the taxpayers understandably wonder why they should pick up the burden of financing services that benefit exempt properties. (See also the discussion of PILOTs and user fees, in Part III, below.)

In *Provena*, the Illinois Supreme Court’s plurality opinion included the novel proposition that “reducing the burdens of government” requires that the government whose burden is reduced must be the same government that would collect revenue if the property were taxable. Specifically, the three justices declared: “While Illinois law has never required that there be a direct, dollar-for-dollar correlation between the value of the tax exemption and the value of the goods or services provided by the charity, it is a sine qua non of charitable status that those seeking a charitable exemption be able to demonstrate that their activities will help alleviate some financial burden incurred by the affected taxing bodies in performing their governmental functions.” The concurrence/dissenting opinion disagreed with the plurality’s premise: “Alleviating some burden on government is the reason underlying the tax exemption on properties, not the test for determining eligibility. Despite acknowledging this (slip op. at 19-20), the plurality converts this rationale into a condition of charitable status. I neither agree with this, nor do I believe that Provena Hospitals failed to show it alleviated some burden on government.”

Compare a similar argument raised and rejected in Kansas, where an appeals court held that the statute was

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73See posting by CommonGood Vermont on May 3, 2015, at http://blog.commongooodvt.org/2015/05/vt-senate-passes-budget-tax-bills-mostly-preserve-charitable-deductions/ (quoting bill language defining “qualified donee” as “a donee that provides a direct benefit to a charitable cause in this State”). The bill included a favorable presumption if “(ii) the [charitable] donee maintains a physical presence, local affiliate, or chapter within the State, or within 25 miles of the State; and (iii) at least some part of the donee’s charitable work occurs within the State, or within 25 miles of the State.” Finally, the bill would have required the tax department to publish, by December 1 each year, “the list of donees who are considered qualified under this section for the current tax year.”

74Chapman v. Commissioner of Revenue, 651 N.W.2d 825, 833-35 (Minn. 2002).


76Id. at 1148. The plurality identified the 10 taxing jurisdictions interested in this case: “Champaign County, Champaign County Forest Preserve District, Community College District 505, Unit School District 116, Urbana Corporation, Cunningham Township, Urbana-Champaign Sanitary District, Urbana Park District, Champaign-Urbana Mass Transit District, and Champaign-Urbana Public Health District.” Id. The opinion noted: “In reaching this conclusion, we do not mean to suggest that Provena Hospital’s entitlement to a charitable property tax exemption was dependent on its ability to show that its use of the PCMC parcels reduced the burden on each of the affected taxing districts. It was, however, required to demonstrate that its use of the property helped alleviate the financial burdens faced by the county or at least one of the other entities supported by the county’s taxpayers.” Id. at note 10.

77Burke, J., at 1159. The concurrence/dissent could have made a different point about “alleviat[ing] some financial burden incurred by the affected taxing bodies.” If we don’t care about federal tax policy, as the plurality suggests, then getting inadequate compensation from Medicare and Medicaid should count as making a gratuitous transfer to the local government that would otherwise have to care for these patients!

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satisfied when “the evidence shows that [Boy Scouts of America] served the needs of the Boy Scout community in its 30-county region, which included Chautauqua County [where the property was located].”88 The court explained:

The County argues on appeal that community need should be assessed based on meeting a need within the County where the property is located. The argument is premised on the fact that Chautauqua County will bear 100% of the burden if the ranch acreage is removed from the tax rolls, so the County suggests that, to be exempt, the property should be meeting a need within the “community” of the county affected. Such a provincial conception of community need has never been recognized by our caselaw construing 79-201 Ninth. For purposes of this statutory exemption, community need must not be assessed solely based on services within the county where the property is located.

III. Local Self-Help: User Fees and PILOTs

A. Data Deficiencies

As a threshold matter, research into property tax exemption suffers from two serious data issues: No ready database exists of real estate owned by nonprofits, and estimates of current fair market value are hard to come by. Looking at holdings of land, buildings, and equipment on Forms 990 (for circa 2009) shows that 52.2 percent of filing nonprofits reported amounts greater than zero; 30.3 percent reported amounts greater than $100,000; and 19.2 percent reported amounts greater than $500,000.89 These self-reported amounts are likely to be book value, and property rolls are even less reliable because assessors have little incentive to spend time valuing property that will not be taxed.

Not surprisingly — in light of their extensive real estate holdings, for-profit competitors, perceived profitability, and even high executive salaries — nonprofit hospitals (and, to a lesser extent, universities) have attracted the most attention from reformers and researchers. A 2015 report published in Health Affairs examined the value of all tax benefits, federal and state, provided to nonprofit hospitals.90 Overall, the estimated $24.6 billion in forgone taxes looks like a good deal compared to the $62.4 billion of community benefits hospitals reported to the IRS.91 This study found that “estimating the value of the property tax exemption is the most challenging because the methods for appraising hospitals are complex, and the data are difficult to obtain: We relied on a method that uses patient revenue — that is, the amount of revenue generated by patient care — instead of expected earnings to estimate the property value and corresponding property tax. This method has the limitation of assuming that all facilities are equally profitable. In addition, property tax rates vary by municipality, and we were not able to account for this variability.”92 The report found: “Applying the state-specific property tax-to-revenue ratio to each nonprofit hospital, we estimated a total property tax value of $4.3 billion (Exhibit 1).”93

Similarly, systematic PILOTs literature is sparse. See Parts III.B and C, below, for a discussion of a broad survey by the Lincoln Institute84 and a survey focused on Illinois.95

B. Intermediate Tools: First User Fees, Then PILOTs?

Inching toward a negotiated tax result, municipalities seeking to recoup from nonprofits some of the costs of public services provided to their property can turn to user fees and PILOTs (or both).

Unless provided by statute, nonprofit property owners enjoy no exemption from user fees for specific services (such as water, sewage, and trash collection) or from special assessments that relate to improvements that benefit specific property. This feature is not lost on local governments: Census Bureau data from several years ago show that only 30 percent of municipalities’
As a political and strategic matter, however, the municipality cannot simply target user fees just to nonprofit owners; for example, a water charge has to apply to all similarly situated property regardless of the type of owner. Also, user fees and assessments cannot recoup the general portion of the forgone tax, notably the amount paid for public schools. Moreover, courts will strike down fees to cover the costs of providing essential services, like police and fire protection, that are really disguised taxes from which charities are exempt. Legislative proposals emerge from time to time that would authorize the municipalities to collect a “service fee” to replace a portion of lost tax, but so far, none has been enacted.98

Unlike user fees, PILOTs are voluntary. Accordingly, the Lincoln Institute PILOTs study (discussed below) explains: “While the term PILOT can refer to many different types of payments, this report imposes a consistent definition that includes any payments from for-profit companies or public entities (e.g., housing authorities) and any payments from nonprofits that are not voluntary, such as fees.”99 Intriguingly, though, the Illinois study suggests that municipalities that seek non-profit PILOTs typically have already imposed user fees — and, indeed, view PILOTs as a last resort.100


8 With respect to educational institutions, a “tuition tax” or head tax on students has been beaten back everywhere in the country it has been proposed (notably in Providence and Pittsburgh), but the idea remains attractive to revenue-hungry college towns and cities.

9 Abstract from Langley, Kenyon, and Bailin, supra note 94.

10 Mayhew and Waymire, supra note 95, at 29-30 (“Figure 2 shows that of the nine municipalities reporting a current PILOT agreement [with nonprofits], eight (or 88.9 percent) also charge user fees to nonprofit organizations and have economic development tools including property tax exemptions or abatements. In contrast, only 21 of the 44 cities that report having never considered PILOTs (47.7 percent) also charge user fees and have economic development plans that meet our narrower definition. These results are consistent with our expectations that PILOTs represent a revenue option that will be pursued after having exhausted other options”).

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granted after April 1, 1978); and Rhode Island (by statute for hospitals and schools). More widespread are state-made PILOTs for state-owned real estate. The federal government similarly makes PILOTs under various statutes.

One might think that states would facilitate fair and consistent PILOT programs for their local governments. Uniquely, apparently, Pennsylvania’s 1997 Act 55 (discussed above) encourages nonprofits to make PILOTs. Curiously, the 2011 Illinois statute adding requirements for nonprofit hospitals does not address the compromise approach of PILOTs. The use of “voluntary” PILOTs has not yet become systematic throughout any particular state, much less throughout the country, but is spreading to increasing numbers of financially struggling municipalities. PILOT arrangements vary, sometimes even within a given city or town. Some agreements recognize “services in lieu of taxes” or “SILOTS,” a term that covers a variety of in-kind transactions.102

Moreover, as mentioned above, the likelihood of overlapping local taxing jurisdictions suggests that a charity might receive multiple requests for PILOTs and should be prepared to explain why it might agree to one but not another. Note that the local governments might be competing with each other in the race to obtain voluntary revenue. As Rick Cohen cautioned: “part of the attraction of PILOTs, like abatements for for-profit developers, is that the sponsoring municipality might be able to craftily keep all of the booty for itself. . . . The politics of abatements and exemptions make tax-exempt property owners into pawns in games among taxing jurisdictions.”103

While PILOTs from the eds and meds get media attention, smaller charities and even churches have found themselves the subjects of PILOT requests.104 Given that PILOT agreements are governed by “politics” rather than the law, Cohen advised: “Rather than slugging it out in a scrum with local governments (which are often as revenue-starved as many nonprofits), the nonprofit sector can and should be a partner to local government, drafting the talent within 1.8 million 501(c) entities plus another few hundred thousand churches to come up with long-term solutions that serve the overlapping interests of nonprofits and government alike.”105

2. Data on PILOTs

A 2013 report from the Lincoln Institute provides the most thorough PILOT study available.106 It analyzes three year’s worth of data from a 2011 survey of local government officials in 599 jurisdictions with the largest nonprofit sectors. The report finds that since 2000, at least 218 localities in 28 states collected PILOTs annually, worth, in the aggregate, more than $92 million.107 More than 90 percent of PILOT revenue comes from the eds and meds, with colleges contributing about two-thirds of PILOTs and hospitals about a quarter. As summarized in the report’s abstract:

While at least 420 nonprofits make PILOTs, the majority of revenue comes from just 10 organizations: Harvard University, Yale University, Stanford University, Brown University,108 Boston University, Massachusetts General Hospital, Dartmouth College, Brigham & Women’s Center, Massachusetts Institute of Technology, and Princeton University (in order of payments, beginning with the highest).

The other 10 percent of PILOTs came from various types of surveyed organizations, including housing (47); religious organizations, including churches (36); social

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102 See, e.g., the following discussion of payments included in an agreement between Stanford University and Palo Alto with respect to Stanford’s $5 billion hospital project:

To obtain the city’s permission for the expansion, Stanford has offered a package of community benefits that includes $23.2 million for infrastructure and affordable housing projects; $12 million for climate-change programs; $5.6 million in health-care services for low-income residents; $4 million for community-health programs; $34 million for improved pedestrian and bicycle connections; and $8.1 million in construction-use-tax revenue. Stanford will also pay about $91 million to purchase Caltrain Go Passes for all hospital employees.

While Stanford values the “community benefits” package at about $173 million, the city says it’s closer to $43 million. Palo Alto officials argue that many of the benefits in the Stanford proposal, including the Caltrain passes, are mitigations that hospitals are required to provide to get environmental clearance for the project.


104 Id. See also Karen Setze, “Proposed California Initiative Would Revoke Property Tax Exemptions For Churches,” 2012 State Tax Today 113-3 (June 11, 2012): “California officials have authorized signature gathering for a constitutional amendment to revoke the property tax exemption for churches and other buildings used for worship or other religious purposes. Proposers must turn in 807,615 signatures of registered voters by November 2 to get the amendment on the ballot in 2013.”

105 Cohen, supra note 103.

106 Langley, Kenyon, and Bailin, supra note 94.

107 Most nonprofits make fairly small PILOTs while most revenue generated comes from a small number of multi-million dollar PILOTs. As a result, the average PILOT for all nonprofits ($292,952) is nearly 10 times larger than the median ($30,000).” Id. (abstract).

services (15); and arts/culture (11). Regional differences, as expected, are strong: “The Northeast accounts for roughly 75 to 80 percent of PILOT activity, with the largest share in Massachusetts and Pennsylvania.” From the taxing jurisdictions’ perspective, the report found that PILOTs produced “less than 1 percent of total general revenue in 165 out of 181 localities that have information available.” The survey further found that PILOT agreements typically run long-term (58 percent of localities109) and call for routine annual payments (34 percent).

The recent Illinois survey covered PILOTs negotiated with public and business property owners, as well as with nonprofits. The report determined that “nine of the five municipalities [responding] report having at least one PILOT arrangement currently in place, while the overwhelming majority (44 of 59) have never had, and are not currently considering, PILOTs as a revenue generation tool. . . . The municipalities reported having an average of 2.4 PILOT agreements, with a minimum of one and a maximum of ten. The PILOTs generate an average of $112,689 annually, with a range of $3,000-$600,000. PILOT arrangements are fairly evenly spread across other local governments, state governments, nonprofit entities, and business entities. Only three of the nine municipalities with PILOTs in place report having such an agreement with nonprofit organizations.”110 The authors of this report observe:

Consistent with Brody, Marquez, and Toran (2012) and Longoria (2011), our quantitative analyses and follow-up interviews reveal that local government managers are reluctant to pursue PILOT arrangements, particularly with nonprofit organizations, because of the potential political costs of doing so. One manager’s comment was that PILOTs might become more common in Illinois if one municipality would blaze the trail. His comments suggest that if one municipality were able to effectively implement PILOTs without significant political costs, others would follow suit. Political costs may be particularly salient in Illinois given the litigation that has challenged the tax exempt status of nonprofit hospitals based on their aggressive collection practices for charges of the uninsured or underinsured (i.e., charity care).

These trends (political costs, litigation) speak to the basic confrontational tenor that surrounds nonprofit property tax exemption. As long as this area of local government policy remains combative, PILOTs will continue to be seen as a zero sum game where there is a winner and a loser. Viewed alternatively, PILOTs offer a means of engaging the public, nonprofit, and business sectors in a productive dialogue. While the initiation of such a dialogue may be uncomfortable, the successes of the municipalities which have initiated PILOTs, although few in number, suggest that such efforts have the potential to encourage collaboration and therefore contribute to the universal goal of a strong and vibrant community. . . .

Boston continues to run the most comprehensive, and most successful, voluntary PILOT program.112 Following a 2012 conference on the charity property tax exemption, the Urban Institute’s research report summarized the Boston Task Force’s recommendations that:113

PILOTs would remain voluntary; all nonprofits would be asked to contribute except those with total property value less than $15 million; PILOTs would be calculated based on 25 percent of what the nonprofit’s property would yield if taxable; a dollar-for-dollar credit would be offered for SILOTs but limited to 50% of the payment; institutions would receive a credit on their PILOT in the amount of real estate taxes paid on properties that would ordinarily qualify for a tax exemption based on use; and the new program would be gradually phased in over a five-year period. Qualifying SILOTs should directly benefit Boston residents; support the city’s mission and priorities; offer ways the city and institution could collaborate to meet shared goals; and be quantifiable.

The Urban Institute report continued: “Overall, the new PILOT program was considered a success; for the first half of fiscal year 2012, the city received $9.9 million in payments, 92 percent of the $10.8 million requested, and a 24 percent increase over what would have been paid under the prior PILOT program.”114

The Urban Institute reported on the initial lessons learned from Boston’s overhauled program, as described


112Boston’s collections under their revised PILOT program (starting in 2012) are available at http://www.cityofboston.gov/assessing/PILOTProgram.asp.

113Brody, et al., supra note 89, at 9. For an audio of the Urban Institute Panel that included the speaker from Boston, go to http://www.urban.org/taxandcharities/upload/STE-001.mp3.

114Id. at 9.
by Boston official Ron Rakow. Most significantly, nonprofits vastly prefer to give services that benefit the community to giving cash, the city’s preferred type of payment; this might put pressure to adjust the 50 percent credit limit on SILOTs. Also, cultural institutions (notably museums) operate under a different economic model than do the eds and meds, suggesting differing treatment could be appropriate. More broadly, Rakow observed that a successful PILOT program requires time, effort, commitment, and a strong long-term relationship with nonprofit organizations.

Eric Lustig recently provided a comparison of Boston’s collections in each of its first three years with the 2011 base year. He found:

While the overall nonprofit PILOT contributions have increased since the revised program was implemented, the medical sector has a greater overall participation than the other sectors for FY 2011 and years FY 2012 through 2014. Moreover, Table 5 shows the medical sector has a significantly greater percentage of institutions fully participating (i.e., paying the full requested PILOT payment). And as further provided in Table 5, the medical sector has paid in the aggregate an overwhelmingly higher percentage of the requested payments than the other sectors. Indeed, the percentage of fully participating institutions and percentage of requested contributions paid for the education sector has gone down since FY 2012.

3. Recent PILOT Developments: Florida court strikes PILOT as inconsistent with statutory exemption; Rhode Island legislature singles out a college.

In a case on its way to the Florida Supreme Court, a nonprofit buyer of an affordable housing project repudiated a PILOT agreement entered into (and honored) by a nonprofit developer as a condition of qualifying to issue tax-exempt bonds. The appellate court reversed the trial court and held that the new owner could not be compelled to make PILOTs:

We conclude that based on the statutory exemption, the City did not have authority to collect ad valorem taxes from AHF via enforcement of the PILOT agreement. The PILOT agreement violates the public policy of promoting the provision of affordable housing for low to moderate income families and is therefore void. Additionally, we hold that a PILOT agreement that requires a party to make payments that are the equivalent of ad valorem taxes that would otherwise be due but for

a statutory tax exemption violates article VII, § 9(a) of the Florida Constitution, which permits municipalities to impose taxes only as authorized by law.

Because of the breadth and significance of its holding, the court ended by certifying the issue to the Florida Supreme Court, which accepted jurisdiction on December 8, 2015.

At the other extreme, in 2013, as summarized by Rick Cohen: “despite the protests of Bryant University and others, Governor Lincoln Chafee signed a bill that would require Bryant University to pay Smithfield for the costs of police, fire, and rescue services — voluntarily, so to speak — but if Bryant doesn’t agree to a deal to fork over the costs to Smithfield by March 2014, the university will be forced to make the payments to the city.” In the subsequent negotiations, “Smithfield had been seeking a flat $300,000 a year plus $150,000 every four years to help cover the cost of new emergency vehicles.” The university, though, countered: “We simply believe Bryant is already paying its ‘fair share,’ and then some. . . . Town officials are now working with [Bryant’s] consultant and we are optimistic that this collaborative process will result in determining exactly what Bryant’s fair share for


117Id.;

Finally, we recognize that PILOT agreements similar to the one in this case abound in municipalities throughout Florida. Thus, the magnitude of our opinion holding that these types of agreements violate Florida law may pose a significant hardship on municipalities that rely on such payments to meet their budget requirements. We therefore certify to the Florida Supreme Court the following question to be of great public importance:

DO PILOT AGREEMENTS THAT REQUIRE PAYMENTS EQUALING THE AD VALOREM TAXES THAT WOULD OTHERWISE BE DUE BUT FOR A STATUTORY TAX EXEMPTION VIOLATE SECTION 196.1978, FLORIDA STATUTES (2000), AND ARTICLE VII, § 9(a) OF THE FLORIDA CONSTITUTION?


public safety cost reimbursement is."¹¹² In June 2014 the parties agreed that Bryant would pay the city a flat $25,000 per quarter, adjusted based on actual costs.¹¹³ This compromise (Bryant had considered protesting the statute in court) papers over the concern noted by Cohen "that the Bryant University/Smithfield legislation is particularly odious in that it involves the targeting of a specific institution. Can legislators simply pick and choose targets for special legislative treatment?"¹¹⁴

CONCLUSION

Today the legal question regarding property tax exemption for charities is more properly about who determines what is exempt, and how, as well as whether the affected parties will negotiate a partial payment. The three topics described above — constitutional power, statutory interpretation, and the "intermediate sanctions" of user fees and PILOTs — braid together to form the procedural framework for the financial relationship between nonprofit property owners and the taxing jurisdictions that host them.¹¹⁵ Change the parameters of one, and you change the others. As observed of the debate in Pennsylvania: "When State Auditor General Eugene DePasquale (D) held a public hearing in March in Pittsburgh on SB 4, which would give the state legislature rather than the courts the authority to define which group is a purely public charity and, therefore, able to avoid paying certain taxes, township officials expressed concern . . . that Wolf's proposed legislation will limit their ability to negotiate payments in lieu of taxes."¹¹⁶

But statehouses are beginning to pay attention to the woes of their municipalities: "Data from the National Conference of State Legislatures and the National Council of Nonprofits show that in the last three years, a majority of states have established tax task forces to scrutinize tax exemptions and credits, and about a dozen states have given serious consideration to repealing tax exemptions for nonprofits."¹¹⁷ This account added: "Hospitals and private universities are big businesses, [New Hampshire Rep. David] Hess told Tax Analysts, arguing that despite being organized as nonprofits, they are among the state's largest accumulators of wealth. 'I think we need to start a conversation about why we are carving out a special exception for them.'"

This debate will continue as it has been waged: contingent, messy, and ad hoc. Exemption for most charities in most states will endure. Some states will see repeated skirmishes prompted by localities hosting significant exempt property, and a few courts will mediate turf battles between legislatures and the judiciary. Occasionally, though, exemption will be beside the point, as vulnerable property owners — particularly those that earn significant profits, pay high executive salaries, and have for-profit competitors — will face pressure to make "voluntary" PILOTs or provide SILOTs.¹¹⁸

APPENDIX

ADDITIONAL SELECTED RECENT CITATIONS ON PROPERTY TAX EXEMPTION FOR CHARITIES AND PAYMENTS IN LIEU OF TAXES (PILOTs)¹¹⁹

NOTE: I rely on the following three essential (and free) sources to keep current —


For the late Rick Cohen’s irreplaceable coverage of state and local tax issues for The Nonprofit Quarterly, use the search box at www.nonprofitquarterly.org.

¹¹²Michael E. Fisher, Chair, Bryant University Board of Trustees, Letter to the Editor, “Consultant, Town, Will Decide Bryant’s ‘Fair Share,’” [Smithfield, RI] Valley Breeze & Observer, Dec. 12, 2013. The letter explained: “For the year 2013, Bryant will have paid the town approximately $1.5 million in voluntary payments, property tax payments, fees, and in-kind contributions including paying for the annual Independence Day fireworks and hosting Smithfield High School’s graduation ceremonies.” It added: “All of what Bryant does is in addition to the nearly $500,000 annually that Smithfield receives from the State of Rhode Island as part of their Payment in Lieu of Taxes (PILOT) program intended to compensate for any burdens an institution of higher learning might place on local resources such as fire or police services.”¹¹³Melanie Thibeault, “The Year in Smithfield,” [Smithfield, RI] Valley Breeze & Observer, Jan, 8, 2015.

¹¹⁴See also Grønbjerg & McGiverin-Bohan, supra note 111 (“[D]etails about existing or proposed PILOT policies are very difficult to come by, suggesting that the actual payment of property taxes is not the primary consideration. Rather, PILOT policies are at least in part symbolic politics — occasions for local government officials and spokespersons of local charities to negotiate their mutual dependencies and relationships.”)


¹¹⁶Jennifer DePaul, “Short on Revenue, State and Local Governments Exert Pressure on Nonprofits,” 2014 State Tax Today 17-1, Jan. 27, 2014. This account described a separate proposal that failed to advance in 2015: “In New Hampshire, Rep. David Hess (R) on January 8 introduced a bill (HB 1509 (Doc 2014-804)) to expand the business enterprise tax to include large nonprofits, colleges, and universities. The tax is a 0.75 percent levy on interest, dividends, and compensation above a threshold. The bill would exempt churches and other religious institutions and would apply only to nonprofits with more than $1.5 million in gross operating expenditures annually, according to a fiscal note.”¹¹⁷Academics might not be helping! See Mayhew and Waymire, supra note 95, at 33: “We interviewed four managers for cities that reported no current or planned PILOTs. All four reported that until the survey, the potential for PILOT arrangements with nonprofit entities had never come up in discussions.”¹¹⁸This selected bibliography does not include sources cited in the substantive discussion above.
STATE-BY-STATE DEVELOPMENTS

Set out, in state alphabetical order, is an account of almost all state supreme court property tax exemption decisions, plus other major developments, since my 2012 bibliography and not otherwise addressed in the text, above. Note that lower court decisions, particularly trial level or Tax Tribunal decisions, are typically more adverse to the claimant.

Connecticut:

In June 2015 the Connecticut Senate rejected a proposal by the House to allow municipalities to tax real and personal taxable property acquired by nonprofit hospitals (but not their main facility) acquired on or after October 1, 2015, and to tax nonprofit colleges’ and universities’ student housing, regardless of when acquired, other than dormitories with at least 20 beds. See Jennifer Carr, Connecticut Senate Rejects Bill to Make Hospital, University Property Taxable, 2015 State Tax Today 108-4 (June 5, 2015); Neil Downing, Connecticut Looking to Tax Hospital, College Property, 2015 State Tax Today 104-5 (June 2015).

Louisiana:


Louisiana jurisprudence provides that exemptions of property devoted to charitable purposes are justified only on the theory that the charitable acts alleviate the burdens of government. [Citing Sherwood Forest Country Club v. Litchfield, 2008-0194, pp. 5-6 (La. 12/19/08), 98 So.2d 56, 621] Historically, exemptions were allowed based on the theory that the concessions are due as quid pro quo for the performance of services that are essentially public. [Footnote omitted.] In other words, the charitable purposes of the nonprofit corporation must alleviate the burdens of government. [Footnote omitted.]

Maine:

As reported by the National Council of Nonprofits on May 4, 2015:

A key committee of the Maine Legislature rejected two bills related to taxing the property of nonprofits. One bill would have allowed municipalities to hold public votes to deny tax-exempt status to land trusts that are 20 acres or larger. Another measure would have ordered a study to examine the nonprofit property tax exemption and determine whether the loss of revenue to a municipality is outweighed by the benefits provided to the community by the nonprofit organization.

Francis Small Heritage Trust, Inc. v. Town of Limington, 98 A.3d 1012, 1021 (Me. 2014) (“the Trust essentially operates its properties in the manner of a state park...[and so] assists the state in achieving its conservation goals”). Citing decisions from California, Florida, Massachusetts (see below), New Mexico, Ohio, and Vermont, the court observed that “[a]ppellate courts in several other jurisdictions have concluded that land conservation is a charitable purpose, at least when coupled with public access, or where conservation of the land otherwise confers a public benefit.” Moreover: “There can be little doubt that the Legislature has enacted a strong public policy in favor of the protection and conservation of the natural resources and scenic beauty of Maine.” [But see North Carolina, below.]

Hebron Academy v. Town of Hebron, 60 A.3d 774, 782 (Me. 2014) (affirming the finding that because “Hebron Academy’s rental activity amounted to approximately one percent of its operating budget and did not interfere with its tax-exempt purpose...Hebron Academy’s property rental is a de minimis ‘incidental use’”).

Massachusetts:

New England Forestry Foundation v. Board of Assessors of Town of Hawley, 9 N.E.3d 310 (Mass. 2014) (holding exempt land owned by a charitable conservation organization and open to the public; ruling further that the nonprofit owner of conservation land to which the public is denied access carries a heightened burden to qualify for exemption. [Compare Maine, above, and North Carolina, below.]

Michigan:

The anomalous SBC Health Midwest Inc. v. City of Kentwood, 2015 Mich. App. LEXIS 578 (March 19, 2015), reversed and remanded the denial of the Tax Tribunal decision, ruling that under the unambiguous language of the relevant exemption statute “an educational institution incorporated under the laws of this state” need not be a nonprofit organization.

Nebraska:

Harold Warp Pioneer Village Foundation v. Ewald, 287 Neb. 19 (Neb. 2013) (holding exempt a motel and campground, owned and exempt since 1984, primarily used by patrons of a nonprofit museum). “The museum is an educational institution designed to preserve history and technology for future generations. The museum displays approximately 50,000 exhibits in 28 buildings on 20 acres of land. A museum patron wishing to view every exhibit offered would need to visit the museum every day for more than 1 week. Approximately 30 percent of museum patrons spend more than 1 day viewing the exhibits.”

New Jersey:

Advance Housing Inc. v. Township of Teaneck, 74 A.3d 876 (N.J. 2013) (holding exempt a nonprofit corporation’s residential facilities for individuals with psychiatric disabilities). “Advance Housing is playing a role in fulfilling an articulated State policy of deinstitutionalizing the mentally disabled. In doing so, it also is relieving the State of the expense that it would otherwise bear in housing and caring for the mentally disabled.”

New York:

In the Matter of Greater Jamaica Development Corporation v. New York City Tax Commission, (July 1, 2015), http://www.courts.state.ny.us/REPORTER/3dseries/2015/2015_05620.htm (“The parking facilities may very well provide a ‘public benefit,’ but the overall use to which these
facilities are put, i.e., to further economic development and lessen the burdens of government, cannot be deemed ‘charitable’ within the meaning of section 420-a(1)(a).”)

Merry-Go-Round Playhouse Inc. v. Assessor of the City of Auburn, 23 N.E.3d 984 (NY 2014): “Petitioner established that the housing is used to attract talent that would otherwise look to other theaters for employment, that the living arrangement fosters a sense of community and that the staff spends a significant portion of its off-hours in furtherance of theater-related pursuits. In addition, **petitioner would have difficulty recruiting qualified staff if it did not provide the housing, which would undermine its primary purpose. Although we have not previously addressed the provision of tax exempt housing in relation to an arts organization, the statute does not elevate one exempt purpose over another.”

North Carolina:

In re Grandfather Mountain Stewardship Foundation Inc., 762 S.E.2d 364 (N. Car. App. 2014) (reversing the state property tax commission, holding that land owned by a nonprofit land stewardship foundation was not used wholly and exclusively for scientific and educational purposes because it included commercial enterprises that sold goods to support the nonprofit). As someone who 25 years ago hiked up to the summit and paid on the spot for lodging (where the dinner menu offered only two selections, ostensibly because no one would stay more than two nights), I was fascinated by the findings:

President Dameron testified that prior to 1950, Grandfather Mountain was not a travel attraction; individuals visited Grandfather Mountain to hike and explore. Subsequently, the owner of Grandfather Mountain “set about converting it into a more formalized, accessible attraction. . . . Of the improvements constructed, President Dameron noted a swinging bridge, a small woodcarving shop, two guest cottages, a visitor’s center, an animal habitats center, a museum, a fudge shop, and an administrative offices building. In 2010, 244,215 guests visited Grandfather Mountain. Gift shops located in the museum and the visitor’s center sold retail items, such as hiking equipment, souvenirs, and snacks. Honey, jelly, fruit, woodcarvings, and books on woodcarving were also sold on the property. Within the nature museum, visitors could purchase food and beverages from an on-site restaurant; nearby, treats could be purchased from a free-standing fudge shop. President Dameron also noted that in 2010, GMSF recognized $1,108,971.00 in profit from retail sales.

The court noted additional uses, and pointed out that: “The land parcels comprising Grandfather Mountain are also subject to a conservation easement with the Nature Conservancy, and have been honored with conservation awards and designated a United Nations Biosphere Reserve. The record supports that the attraction of Grandfather Mountain offers educational and scientific presentations about birds, reptiles, animals, and native flora and fauna; and that revenue from the operations on the property is used to further educational and scientific uses on the property.” LEXIS reports that the state Supreme Court dismissed the appeal as moot.

Ohio:

Grace Cathedral Inc. v. Testa, 2015 Ohio LEXIS 1379 (Ohio 2015) (4-3 decision) (holding a church’s recently constructed dormitory qualified for the public worship property tax exemption because its primary use facilitated attendance at the public worship service of the church in the principal, primary, and essential way). The lengthy dissent opens with: “The dormitory at issue in this case is essentially a free hotel”; the dissent later observes: “The dormitory was built to provide residential housing for students at an on-site college that never came to be; it was not built because overnight housing was needed for Grace Cathedral to be able to accommodate public worship.” As a legal matter, the dissent complains that the majority “erroneously placed the burden on the tax commissioner to establish why Grace Cathedral’s application should fail.”

Oklahoma:

AOF/Shadybrook Affordable Housing Corp. v. Yazel, 282 P.3d 775 (Okla. 2012) (“We find that Shadybrook has overcome its burden of proving the existence of an exemption and has demonstrated that its operation of the low-income housing complex was a charitable use entitling it to the ad valorem tax exemption in § 6. London Square Village is overruled. The statutory language in 68 O.S. 2004 § 2887(8)(a)(2)(b) excluding property funded with proceeds from the sale of federally tax-exempt bonds from ad valorem exemption is unconstitutional.”).

Vermont:

Brownington Center Church v. Town of Irasburg, 87 A.3d 502 (Vt. 2013) (denying a “pious use” exemption to a church-owned camp because the legislature did not expressly exempt church camps, the church’s description of the camp as an exempt “church edifice” “stretches the statutory term far beyond its ordinary meaning”).

127 The court quoted Brody, supra note 6, at 635 (“Courts must ‘recognize that the concept of charity evolves over time to take into account the changing needs of society, new discoveries, and the varying conditions, characters, and needs of different communities.’.”)
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Why Your Organization Should Care About the Final Allocation and Accounting Regulations for Bond-Financed Facilities

by Vicky Tsilas and Lauren K. Mack

On October 27, 2015, the IRS and Treasury Department released final regulations on allocation and accounting, as well as some remedial actions, for purposes of the private activity bond restrictions under section 141. Although it took nine years for the proposed regulations (REG-140379-02; REG-142599-02) to be finalized, the IRS and Treasury provided welcome flexibility for financing mixed-use projects, as described below, as well as entering into partnerships with private parties. The regulations apply to governmental bonds and to qualified section 501(c)(3) bonds under section 145.

History of Final Regulations

In general, interest on bonds issued by state and local governmental entities (governmental issuers) is excludable from gross income under section 103 upon satisfaction of particular requirements. One key limitation is the amount of use of the bond proceeds by persons other than governmental entities, commonly referred to as private use. Because section 501(c)(3) organizations are not governmental entities, interest on bonds issued by governmental issuers for the benefit of a section 501(c)(3) organization generally is tax exempt only if the bonds meet the requirements for qualified 501(c)(3) bonds. In this article, we will refer to state and local governmental entities and section 501(c)(3) organizations engaged in exempt activities as “qualified users.”

Section 141 provides specific tests that are used to determine whether a state or local bond is a private activity bond. These tests include the private business use test and the private security and payment test in section 141(b) and the private loan financing test in section 141(c). Section 145 provides similar tests that apply in modified form to qualified 501(c)(3) bonds.

Final regulations (TD 8712) under section 141 were published on January 16, 1997, (62 FR 2275) to provide comprehensive guidance on most aspects of the private activity bond restrictions. The 1997 regulations reserved most of the general allocation and accounting rules for tax-exempt bond proceeds to finance mixed-use projects and rules regarding treatment of partnerships for purposes of section 141 (proposed allocation regulations). An NPRM and notice of public hearing (REG-132482-03) were published on July 21, 2003, (68 FR 43059), regarding the amount and allocation of nonqualified bonds for purposes of particular remedial actions under sections 141 and 142 (proposed remedial action regulations). Final regulations (TD 9150) were published on August 13, 2004, (69 FR 50065) adopting the portion of the proposed remedial action regulations relating to section 142. Because of the interrelationship between the remedial action provisions under section 141 and the allocation and accounting regulations, the portions of the proposed remedial action regulations relating to section 141 were not finalized then. The final allocation and accounting regulations released in October 2015 finalize the portions of the proposed remedial action regulations relating to section 141 that were still outstanding.

What Do the Final Regulations Do?

In general, allocation and accounting rules play a role in determining, among other things, whether bonds are qualified 501(c)(3) bonds under section 145. As indicated above, the 1997 final regulations already exist for measuring the extent of private business use of a facility. The 1997 regulations provide that if a facility is financed...
exclusively with qualified 501(c)(3) bonds, up to 5 percent private business use is permitted. The accounting rules are relevant when a facility being financed is used by both qualified users and private users (referred to as a mixed-use facility). The new final regulations provide guidance on how to have more than 5 percent private business use of a facility when using less than 100 percent tax-exempt bond financing. The final regulations provide a method to identify the portion of a mixed-use project that is used by qualified users. The basic principle behind the rules is that mixed-use financing should be permitted when the financing reflects the proportionate benefit derived by the users.

Below are some highlights of the rules for section 501(c)(3) borrowers.

**What is a Mixed-Use Project?**

The final regulations define an “eligible mixed use project” as a project that is financed with (1) proceeds of bonds that when issued purported to be qualified section 501(c)(3) bonds and (2) “qualified equity” under the same plan of finance. An eligible mixed-use project must be wholly owned by one or more qualified users or by a partnership in which at least one qualified user is a partner. Qualified equity is defined as taxable bonds (other than tax-advantaged bonds) and funds that are not derived from a borrowing. It does not include equity interests in real property or tangible personal property or funds used to redeem or repay governmental bonds.

**Expanded Definition of What Constitutes a “Project”**

The proposed regulations defined a project as one or more facilities or capital projects, including land, buildings, equipment, or other property that are functionally related or integrated and located on the same or adjacent sites or on geographically proximate sites that are reasonably expected to be placed in service within the same 12-month period. Commentators said the definition was too narrow because it included only geographically proximate facilities placed in service within a short period. In response, the final regulations simplify the definition of “project” to cover one or more facilities or capital projects, including land, buildings, equipment, or other property financed in whole or in part with proceeds of the bond issue.

**Undivided Allocation Method as the Exclusive Method for Mixed-Use Projects**

The proposed regulations provided two alternative elective allocation methods for a mixed-use project: the discrete physical portion allocation method (discrete portion method), and the undivided portion allocation method (undivided method). Each method was subject to specific limitations and required an election.

The final regulations expand the availability of the undivided portion allocation method to include all measurable use and made the undivided method the exclusive allocation method for eligible mixed-use projects. The final regulations limit the need for an election for the undivided method and confirm the use of floating allocations without further action or special tracking. The use of the undivided allocation method without a requirement for a special election and the ability to do floating allocations provide great flexibility to section 501(c)(3) borrowers who will have private business use in their facilities.

For example, a state agency issues $70 million in bonds for the benefit of a section 501(c)(3) organization. The organization also uses $30 million in equity to finance the construction of a facility costing $100 million. If the private business use of the project does not exceed 30 percent in any particular year, the equity is allocated to the private business use. If private business use is 44 percent in a year, equity would be allocated to the 30 percent and bond proceeds would be allocated to the 14 percent resulting in private business use in that year of 20 percent.

**Partnerships: Changing the Landscape for Bond-Financed Facilities**

Perhaps the most significant item in the final regulations are the rules on the treatment of partnerships for bond-financed facilities. The proposed regulations provided rules on the treatment of partnerships for purposes of section 141 by generally treating a partnership as an entity that is a nongovernmental person, with a limited exception when a partnership was treated as an aggregate of its partners if each of the partners is a qualified user. Although these partnership rules would also have applied for purposes of qualified 501(c)(3) bonds, the aggregate treatment was limited to the private activity tests, excluding the aggregate treatment’s use for the ownership test.

The final regulations retain the aggregate treatment for partnerships consisting exclusively of qualified persons for purposes of the private activity requirements under section 145(a)(2). Also, the final regulations include two provisions that allow section 501(c)(3) organizations greater flexibility when looking to finance joint venture assets.

The final regulations extend the application of the aggregate treatment of partnerships to the ownership test for qualified 501(c)(3) bonds under section 145(a)(1). The final regulations also permit the aggregate treatment of partnerships with private entities and qualified users for purposes of section 145(a) and provide rules for measuring the use of bond-financed property by a private partner. The amount of use by the private partner will be based on that partner’s greatest share of the partnership items in any one-year period. For example, assume a partnership uses 25 percent of a bond-financed asset. If the partnership has a partner that is not a qualified user and that partner’s share of partnership items varies, with the greatest share being 45 percent, then that partner’s share of the partnership’s use of property is 25 percent of 45 percent, or 11.3 percent.

This partnership rule is a great step forward for section 501(c)(3) organizations seeking to enter into arrangements with private parties because it permits flexibility in structuring arrangements that will not jeopardize the tax-exempt status of the bonds. The need for this type of rule is evident both by the increased interest in and the discussions regarding structuring joint undertakings for healthcare, research, and educational projects.
Indeed, the preamble to the final regulations acknowledge that the change was made “in recognition of the development of various financings and management structures for government or tax-exempt organization facilities that involve the participation of private businesses to provide flexibility to accommodate public-private partnerships and to remove barriers to tax-exempt financing of the government’s or tax-exempt organizations portion of the benefit of the property used in joint ventures.” Such a resounding acknowledgement of change in the preamble shows that the regulators are trying to bring the tax rules up to date and to further reflect the realities of current business practices for tax-exempt organizations, including universities and hospital systems.

Anticipatory Remedial Action
The proposed regulations included an anticipatory redemption provision that was applicable only under limited circumstances. An anticipatory redemption allows a section 501(c)(3) organization to preserve the tax-exempt status of its bonds by redeeming bonds before the actual change in use. This type of remedial action provides added flexibility and can also help avoid difficulties in determining exactly when the change in use occurs.

The IRS received comments noting the limited usefulness of the provision as proposed and saying the provision seemed contrary to the policy of leaving bonds outstanding no longer than necessary. In response, the final regulations incorporate into the remedial action regulations the option of an anticipatory redemption or defeasance of bonds if the governmental issuer declares its official intent to redeem or defease all of the potentially nonqualified bonds in the event of a subsequent deliberate action that would cause the bonds to cease complying with the requirements of section 145, identifies the relevant bond-financed property, and describes the deliberate action that could result in the section 145 requirements no longer being met (for example, sale of financed property that the buyer may then lease to someone other than a qualified user).

Consistency Requirement
The final regulations provide that an allocation of proceeds to expenditures for purposes of the arbitrage investment restrictions also applies to expenditures for purposes of the qualified 501(c)(3) bonds tests. This means that if bond proceeds are allocated to the cost of building to determine when the proceeds are spent for purposes of the arbitrage rules, those proceeds are also treated as financing that building for purposes of the private use test and the 120 percent useful life test.

When Can These Regulations Be Applied?
The final regulations generally apply to bonds sold and deliberate actions that occur, on or after January 25, 2016. Issuers and conduit borrowers may apply the partnership provisions and the allocation and accounting rules in whole but not in part to any bonds to which the current regulations apply.

What Should We Expect Next?
Although the finalization of these regulations is a significant step forward for the bond community, there is still great work to be done by the regulators to clarify and address questions that will undoubtedly surface as practitioners look to apply these regulations to future financings. In fact, the National Association of Bond Lawyers, the leading trade group for bond practitioners, has already announced it will submit comments on the final regulations to the IRS and Treasury. Moreover, interestingly enough, the preamble to the final regulations clearly states that the IRS intends to publish additional guidance in the partnership area.
Have Americans ever been more passionate about taxes?

Ask Joe.

“The Boston Tea Party … was a revolt against tax loopholes, not high taxes.”

— Joseph Thorndike, PhD
Contributing Editor
Only in the publications of Tax Analysts
The Missing Tax Benefit of Donor-Advised Funds

by John R. Brooks

John R. Brooks is an associate professor of law at the Georgetown University Law Center.

In this report, Brooks discusses donor-advised funds and the tax policy issues they raise. He finds that donor-advised funds generate a small tax benefit at best and may often generate a tax cost for many donors. Further, what little tax benefit is created is largely soaked up by the funds’ investment managers.

I. Introduction

The second largest charitable organization in the country in terms of annual money raised is not the Red Cross, the Salvation Army, or the YMCA — it’s Fidelity Investments. The sixth largest is Charles Schwab Corp. Vanguard Group Inc. is No. 10.1 Needless to say, Fidelity, Schwab, and Vanguard are not running hospitals or soup kitchens. Rather, they are the three largest sponsoring organizations of donor-advised funds (DAFs).

DAFs are accounts established by contributions from charitable donors to a sponsoring organization that pools and manages many different DAFs.2 The DAF then makes distributions to operating charities based on the advice of the donor.3 Because the sponsoring organizations are, by definition, described within section 170(c),4 contributions by a donor into a DAF are tax deductible.5 Importantly, the DAF need not make any distributions immediately for the original donor to receive the deduction. Because the donation is to the sponsoring organization itself, and the sponsoring organization is a charitable organization, the original gift is fully deductible.

DAFs have grown immensely in recent years. According to the National Philanthropic Trust, there are now more than 238,000 DAFs that together hold more than $70 billion in assets.6 In 2014 contributions to DAF were $19.66 billion, and DAFs made $12.49 billion in distributions to operating charities.7 The average DAF has about $296,000 in assets,8 so they are sometimes described as mini-private foundations and marketed accordingly. For those without the assets or interest to set up and operate a private foundation, DAFs achieve a similar result with less cost and hassle. What’s not to love?

However, DAFs do not provide the tax benefits that are sometimes assumed. Although they are certainly more tax beneficial than private foundations, that’s a pretty low bar.9 In fact, in many situations DAFs impose a net tax cost on most donors relative to a direct donation. Moreover, a donor would in many cases be worse off donating today to a DAF than waiting and later donating directly to the operating charity. Taking an immediate and large deduction does not in itself create a tax benefit relative to taking a deduction later and may even create a tax cost. As I show below, this is because of the interaction of the deduction with the ability to avoid capital gains taxation on donations of appreciated property — because the value of a future deduction can grow tax free in a donor’s personal account, donating today to a DAF to get an immediate deduction will not be beneficial. The ability to avoid capital gains taxation also means that the value of tax-free growth in a DAF is limited to the taxes on annual income, like interest, dividends, and any net capital gain from rebalancing.

Furthermore, in the cases where there is some positive tax benefit, the additional management fees imposed by the sponsoring organizations eat away most or all of it. Fidelity, Schwab, and Vanguard charge annual fees of 0.6

2See section 4966(d)(2)(A). A DAF does not include a fund or account that makes distributions only to a single, identified organization or government entity (section 4966(d)(2)(B)(i)), or one for which the donor or the donor’s designee advises on which individuals receive grants for travel, study, or other similar purposes under some circumstances (section 4966(d)(2)(B)(ii)).
3See section 4966(d)(2)(A)(iii).
4See section 4966(d)(1).
5See section 170(a) and (c).
7Id.
8Id.
9For example, private foundations have a lower percentage limitation on gifts (see section 170(b)(1)(B) and (D)), and the deduction for gifts of appreciated assets is often limited to the donor’s basis (see section 170(e)(1)(B)(iii)). Further, private foundations face a series of excise taxes. See, e.g., sections 4940 (2 percent tax on net investment income), 4941 (excise taxes on self-dealing), 4942 (excise tax on undistributed income), and 4943 (excise tax on excess business holdings).
percent of assets for the first $500,000 in each DAF, in addition to any investment fees charged by the underlying mutual fund or other investment vehicle.\textsuperscript{10}

If my claims are right, the rapid growth of DAFs is a bit of a puzzle. While some of that growth can perhaps be explained by donors who truly value the nontax benefits of a DAF, some is likely the result of a misunderstanding of the tax benefits, in part because of marketing by the sponsoring organizations. That said, DAFs provide real benefits from the simplification and centralization of giving. If the fee for those services (0.6 percent of DAF assets) is offset by any tax benefits from holding assets in a DAF, in a sense taxpayers are picking up the tab for the simplification services. Therefore, the tax benefit of a DAF isn’t missing; it’s just being soaked up by the DAF sponsoring organizations as a fee for their services.

II. Background on DAFs

Although DAFs have grown rapidly in recent years, their basic structure goes back to at least the 1930s. The first were established by community foundations (also known as community trusts), which pool donations from many donors to centralize investment and grant-making. The first community foundation was likely the Cleveland Foundation, established in 1914.\textsuperscript{11} For the first few decades, community foundations existed just as one pool of money controlled by the foundation itself. But in 1931 the New York Community Trust established the first DAF\textsuperscript{12} — a separate pool that was controlled by the foundation but gave the donor some voice on distributions in the form of advice. Another DAF was created in 1935,\textsuperscript{13} and more followed.

In 1969 Congress amended the tax code to impose tighter rules on gifts to private foundations,\textsuperscript{14} but it provided a carveout for foundations that operate like community foundations — those that pool donations into a common fund and meet specified payout requirements.\textsuperscript{15} Those foundations are treated as publicly supported 50 percent charities — those for which donors can take a donation deduction of up to 50 percent of adjusted gross income.\textsuperscript{16} If the separate funds or trusts had instead been viewed as separate entities, they would have failed the public support test.

But it was not immediately clear whether DAFs would be given the same benefit. In 1983 the IRS denied tax-exempt status to a foundation that resembled a DAF sponsoring organization, claiming that it was merely a conduit for private foundation-like entities that were using the sponsoring organization as a way to avoid being labeled as private foundations.\textsuperscript{17} Further, the IRS claimed that the foundation was essentially just a money-making venture, because it took fees from the donors to manage the accounts and also from grant applicants.\textsuperscript{18} The foundation brought suit for a declaratory judgment on its tax-exempt status, and the Claims Court held in 1987 that the foundation did in fact qualify for tax-exempt status under section 501(c)(3).\textsuperscript{19}

Perhaps emboldened by that holding, Fidelity established the first commercial gift fund in 1991, and the IRS granted its application for tax-exempt status.\textsuperscript{20} Vanguard followed in 1997\textsuperscript{21} and Schwab in 1999,\textsuperscript{22} as did other commercial sponsoring organizations.\textsuperscript{23} Here, I distinguish the commercial gift funds from the community foundations and trusts that were already operating DAF-type funds. Community foundations are established independently for purposes of charitable grant-making. Commercial gift funds, on the other hand, are established by for-profit investment managers. To be clear, however, many of the issues discussed below are the same whether the DAF sponsoring organization is a community foundation or a commercial gift fund.\textsuperscript{24}

The commercial gift funds have grown rapidly. In 2003 the three main commercial gift funds had total contributions of about $1.1 billion, but by 2013 total contributions had risen to about $6.7 billion. Total assets have similarly grown from $3.7 billion to $24.2 billion. Almost all the growth in assets is from contributions; investment returns have been relatively smaller, averaging 0.96 percent.


\textsuperscript{15}See section 170(b)(1)(F)(iii), added by TRA 1969, section 201(a).

\textsuperscript{16}See section 170(b)(1)(A)(vii) (granting 50 percent charity status to private foundations described in section 170(b)(1)(F)).

\textsuperscript{17}Nat’l Found. Inc. v. United States, 13 Cl. Ct. 486, 490 (1987).

\textsuperscript{18}Id. at 494.


\textsuperscript{20}See Vanguard Charitable, “History of Vanguard Charitable,” available at https://www.vanguardcharitable.org/who_we_are/history.


\textsuperscript{22}See Michael J. Hussey, “Avoiding Misuse of Donor Advised Funds,” 58 Clev. St. L. Rev. 59, 63 (2010); and Madoff, supra note 20, at 1266.

\textsuperscript{23}Indeed, some of the issues may be worse for a community foundation since the investment fees are less transparent.
Seeing this rapid growth, the IRS,26 commentators, and ultimately Congress demanded more scrutiny. In 2000 Treasury proposed tightening up the test for whether a sponsoring organization qualifies as a public charity by requiring a payout rate and that all distributions go to public charities or governmental entities.27 In the Pension Protection Act of 2006 (PPA, P.L. 109-280), Congress added the first statutory definitions of the terms “donor-advised fund” and “sponsoring organization” in enacting excise taxes on non-charitable distributions, excess benefit transactions, and similar misuses of charitable funds.28 The PPA also amended the code to state that contributions to a DAF would not be deductible unless the sponsoring organization meets specified criteria29 and supplies the donor with written acknowledgment that the sponsoring organization has exclusive legal control over the assets contributed.30 The PPA also instructed Treasury to undertake a study on DAFs, in particular on whether the immediate deduction was appropriate given that donors still had some implicit control over the funds and whether DAFs should have a required payout rate.31

In 2011 Treasury issued the required report. The report stated that allowing an immediate deduction is appropriate because the donors part with control of the assets and that the lag between donation and charitable use is no different than in other charitable contexts, such as charitable endowments, and that the same deduction rules used for other organizations should apply. The report also found that payout rates for DAFs are higher than for private foundations, and so it would be “premature to recommend a distribution requirement for DAFs at this point.” Regarding donor advice, the report stated that even if the sponsoring organization feels “an obligation to use donated funds in a manner preferred by the donor,” that does not disqualify the gift from being completed, and that the sense of obligation is not unique to DAFs.32 Treasury implied, however, that additional data and research could suggest different regulatory responses, especially as the effects of the new rules became clearer over time.33

Both before and after the report, commentators have been concerned that a deduction is granted immediately even though the funds won’t be used until some point in the future (or possibly never).34 The implication is that DAFs hurt charities by accumulating assets instead of distributing them, while taxpayers and sponsoring organizations benefit. I share the concern about the harm to charities, but as I show below, donors themselves are also hurt through tax costs and high fees. If, despite this, donors are still attracted to DAFs, it must be because either the nontax benefits are worth the cost or there is a misunderstanding of the tax benefits.

III. The Claimed Tax Benefits of DAFs

In this section I review some of the particular tax benefits claimed for DAF donations. I focus on issues particular to DAFs, especially where there is a timing difference between the contribution to the DAF and the ultimate distribution to an operating charity. There are many other tax advantages to donating property to charity — DAF or operating charity — but I set those aside.35 Similarly, I hold constant the year of ultimate distribution to an operating charity — I thus compare making a current contribution to a DAF today to fund a future distribution with simply waiting and giving directly at the future date. If the DAF actually changes the timing of the ultimate distribution — for example, because a donor would have donated sooner to an operating charity otherwise — that would be a concern for philanthropy.36 However, as I show below, it’s unlikely that a donor gets a tax benefit from delaying the ultimate distribution out of a DAF.

A. Accelerated Deduction

The essential tax policy concern is that donors are getting an immediate and large deduction for amounts that will go to an operating charity only later, or perhaps

28PPA section 1231-1235 (codified at sections 4943, 4958, 4966, and 4967).
29The sponsoring organization cannot be a veterans organization, fraternal society, or cemetery corporation, nor can it be a Type III supporting organization unless it is a functionally integrated Type III supporting organization. Section 170(f)(18)(A). See PPA section 1224.
30Section 170(f)(18)(B).
31PPA section 1266. The IRS issued Notice 2007-21, 2007-1 C.B. 611, requesting public comment on these issues.
33Id. at 83.
34See, e.g., Hussey, supra note 23, at 74; Madoff, supra note 20, at 1265; New York State Bar Association Tax Section, “Report Responding to Notice 2007-21 Concerning Donor-Advised Funds and Support Organizations” (June 6, 2007), at 13-14; Alan Cantor, “Donor-Advised Funds Let Wall Street Steer Charitable Donations,” Chron. Philanthropy, Oct. 28, 2014; and Madoff, “5 Myths About Payout Rules for Donor-Advised Funds,” Chron. Philanthropy, Jan. 13, 2014. Another set of concerns relates to the ability of donors to exercise a degree of control that could lead to private benefit even though they have no legal control. See, e.g., NYSSBA, supra at 21-29. This is less of a concern following the PPA. Further, private benefits of this sort are unlikely to occur for DAFs controlled by the major commercial gift funds. Thus, I assume here that the issues are largely ones of timing and fees, not private benefit.
35For example, I don’t discuss estate tax issues, because a DAF is just one possible way to get assets out of an estate.
never. But in fact there is no tax benefit from accelerating the deduction because the law permits the donor to donate appreciated property directly to a charity without realizing any potential capital gain.\(^37\) Thus, if a donor simply saves the money himself — perhaps in an LLC named for himself and his spouse\(^38\) — and donates appreciated property later, he will get a larger deduction, the value of which will have grown tax free. (I ignore for now any annually taxed income, such as interest or dividends.) Moreover, in many cases there may be an additional tax cost to the immediate contribution to the DAF because the tax savings from the contribution may be reinvested, and the reinvested funds may generate income subject to tax.

Suppose I have appreciated property worth $100 that I would like to use to fund a donation to a charity next year. I expect that property to appreciate 10 percent between now and then. (Or equivalently, I have $100 in cash that will be invested in the same portfolio, whether in a DAF or in my own taxable account.) If I contribute the money now to a DAF, I get a $100 deduction, which, if I’m in the 40 percent bracket, is worth $40 to me. Next year, when the asset will be worth $110, the DAF will distribute the proceeds to the charity. Meanwhile, the $40 value of the deduction, if invested in a similar portfolio, will have grown to $44.

If instead I simply hold the asset, it will be worth $110 to me next year. When I donate it directly to charity,\(^39\) I will get a $110 deduction, which will be worth $44 to me. And of course, I avoid taxes on any appreciation in the asset. Thus, in both cases, next year the charity gets $110, and I get $44.

Indeed, I may actually be worse off in the DAF case because the $4 growth is taxable, leaving me with only $43.20 if I were to convert it to cash that year (assuming a 20 percent tax on capital gains). But in the direct donation case, I get the full $44 (see Table 1). If I hold the asset myself, the value of the deduction grows at a pretax rate of return, whereas if I give the asset to a DAF, the value of the deduction grows at an after-tax rate of return. Essentially, direct ownership of appreciating assets intended to be given to charity later is a better DAF than the DAF itself.\(^40\)

<table>
<thead>
<tr>
<th>Table 1. Accelerated Deduction Example</th>
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</thead>
<tbody>
<tr>
<td><strong>Give to DAF</strong></td>
</tr>
<tr>
<td>Y1 starting cash balance</td>
</tr>
<tr>
<td>Y1 gift</td>
</tr>
<tr>
<td>Value of Y1 tax deduction</td>
</tr>
<tr>
<td>Y2 funds for charity</td>
</tr>
<tr>
<td>Y2 gift to operating charity</td>
</tr>
<tr>
<td>Value of Y2 tax deduction</td>
</tr>
<tr>
<td>Y2 cash balance</td>
</tr>
<tr>
<td>Y2 after-tax cash balance</td>
</tr>
</tbody>
</table>

We get a similar result if the donor grosses up the donation by the amount of the deduction.\(^41\)

Even if the taxpayer doesn’t get an extra benefit from the immediate deduction, is the fisc somehow hurt by allowing it? Unlikely. If the government grants a deduction for the gift to the DAF this year, it lowers its own tax revenue for the year by $40. The argument for incurring this tax expenditure (leaving aside distributional issues) is that it amounts to a subsidy for charitable giving to encourage private spending on public goods. But if no charity is actually occurring in the year of the gift, is that a tax expenditure well spent?

Suppose the government has to borrow money for one year to make up the $40 shortfall. It borrows at some rate well below the 10 percent return that the asset earns —

\[
\text{Year } n, \text{ where } C \text{ is the amount of the contribution, } t_m \text{ is the marginal tax rate, } t_r \text{ is the capital gains tax rate, and } r \text{ is the market rate of return. This reduces to:}
\]

\[
\begin{align*}
(1) & \quad t_m C (1 + r)^n - t_n C (1 + r^n) - t_m C \\
(2) & \quad t_m C (1 + r^n) - t_n C (1 + r^n - 1) \\
(3) & \quad t_n C (1 + r)^n
\end{align*}
\]

Thus, as long as \( t_r \) and \( r \) are both positive, giving later is better. The capital gains rate may be zero, however, if the donor plans to give away the future proceeds of the current deduction as another charitable contribution in a future year, or if the donor dies and the basis of the assets purchased with the deduction is stepped up to fair market value at death.

\(^40\)Algebraically, the tax benefit of giving to a DAF this year is worth:

\[
\text{(Footnote continued in next column.)}
\]

\(^{37}\)The issues discussed here could also apply to donations of publicly traded stock to a private foundation. See section 170(b)(1) and (e)(5).


\(^{39}\)This of course assumes that the charity can accept noncash donations, including non-publicly traded stock. But even if the charity won’t accept them, the donor could simply use a DAF as a conduit, which is totally reasonable. The donor could give the assets to a DAF in the later year and then immediately advise the sponsoring organizations to sell the asset and distribute the proceeds. See infra Section III.F. But that is a separate question from whether a donor should have the DAF hold and accumulate assets for a period.

\(^{40}\)Algebraically, the tax benefit of giving to a DAF this year is worth:  

\[
\text{(Footnote continued in next column.)}
\]

\(^{41}\)With grossing up, we would just divide equations (1) and (3) by \((1 - t_m)\), so the same comparison between (2) and (3) holds. The intuition for why (3) is still better than (2), even though the donor essentially invests the value of the deduction in the DAF, is that the donor in the DAF case ought to gross up only by the present value of the deduction, which as shown in (2), is not 100 percent of the nominal deduction because there will be some tax cost as it grows (see also infra Equation (6)). If the donor grossed up by the full value of the deduction in year 1, she would still have some tax cost in year 2 from the growth in that larger deduction and so would have essentially grossed up by too much.
let’s say 2 percent. Next year it will repay the lender $40.80. But next year there will be an additional $44 in tax revenue because $110 of taxable income goes unsheltered (because the donor gave $100 this year instead of $110 next year). So the government makes a profit — it essentially borrows at 2 percent to lend at 10 percent by accelerating the deduction one year, in addition to the extra 80 cents it earns from the growth in the $40 deduction.42

### Table 2. Government Revenue

<table>
<thead>
<tr>
<th></th>
<th>Give to DAF This Year</th>
<th>Give to Charity Next Year</th>
</tr>
</thead>
<tbody>
<tr>
<td>Y1 tax revenue</td>
<td>$0</td>
<td>$40</td>
</tr>
<tr>
<td>Y1 borrowing</td>
<td>$40</td>
<td>$0</td>
</tr>
<tr>
<td>Y1 interest expense</td>
<td>$.80</td>
<td>$0</td>
</tr>
<tr>
<td>Y2 tax revenue</td>
<td>$44</td>
<td>$0</td>
</tr>
<tr>
<td>Y2 bond repayment</td>
<td>$40.80</td>
<td>$0</td>
</tr>
<tr>
<td>Y2 net cash</td>
<td>$43.20</td>
<td>$40</td>
</tr>
</tbody>
</table>

Under these assumptions, therefore, the government actually increases revenue, in present-value terms, from encouraging earlier donations to DAFs.43 This may be one reason the Treasury report comes down relatively lightly on DAFs.44 Of course, the government should not care simply about revenue maximization but about whether the use of DAFs causes less revenue loss than later direct gifts — that may be one reason for the government not to crack down too hard. On the other side of the ledger, however, is the bigger question of whether DAFs actually lead to smaller future gifts in practice because of poor investment management, high fees, and private benefits.

### B. Tax-Free Growth

In the example above, I assumed that all the return from the assets used to fund the donation is in the form of capital gain. Because capital gain can be avoided simply by donating the appreciated asset, there is nothing to be gained from using a DAF only to avoid taxes on that growth. However, the return from an asset can also take the form of annually taxed items of income, such as interest, dividends, and for mutual funds, capital gains distributions.45 Also, if the asset in question is a diversified portfolio, there may be capital gain realizations when rebalancing between asset classes.46 If the assets produce a lot of that annually taxed income, there is a tax benefit from holding them in a DAF. As a tax-exempt organization, the DAF sponsoring organization would not have to pay any tax on those items of capital gain income, and therefore, more could be reinvested, generating more funds for later disbursement to an operating charity. Brian Galle has thus described the value of donating to a private foundation as essentially avoiding the lock-in effect from holding a portfolio in a taxable account.47

This real tax benefit may in some circumstances be very valuable. Bonds, real estate, and stock of closely held businesses, for example, may produce much of their return in the form of annually taxed cash flows rather than appreciation. Similarly, a company founder or executive may be overly concentrated in that company’s stock and wish to diversify, thus triggering capital gain. But the more likely case is donors simply donating stock or mutual fund shares out of their portfolios, or even just cash.48 For example, Treasury found that in 2005 nearly 96 percent of all noncash contributions were either corporate stock or mutual funds.49

If that’s the case, the benefits from tax-free growth are more limited. First, a well-managed portfolio can often avoid much of these tax costs through, for example, holding more growth stock, aggressive loss harvesting,

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42In other words, the present value of the lost revenue as a result of a future deduction to a charity is greater than the present value of a deduction to a DAF today. The government revenue loss from a contribution C today is simply \( r_m C \). But the present value of the future deduction of C is:

\[
\frac{t_p C(1 + r_m)^t}{(1 + r_g)^t}
\]

where \( r_m \) is the market rate of return and \( r_g \) is the government’s borrowing costs. As long as \( r_m > r_g \), this amount will be bigger in present-value terms than the current deduction.

Key to this result is using the government’s borrowing rate as the discount rate, rather than a market rate of return. While government budgeting uses the government’s borrowing rate, some argue that fair-value accounting, *i.e.*, using a market discount rate, would be a better approach. See, e.g., Congressional Budget Office, “Fair-Value Estimates of the Cost of Selected Federal Credit Programs for 2015 to 2024” (May 2014), at 1-4; and Jason Delisle and Jason Richwine, “The Case for Fair-Value Accounting,” Nat’l Affairs 95 (Fall 2014). My view is that fair-value accounting would not be an improvement over the current accounting rules. See, e.g., David Kamin, “Risky Returns: Accounting for Risk in the Federal Budget,” 88 Ind. L.J. 723 (2013) (arguing against the fair-value method and risk adjustment generally in federal budgeting).

43Note that the return on the tax revenue itself is irrelevant. Having $40 in revenue could allow the government to invest in productive projects that could produce a return (e.g., research and development that increases tax revenue). But in my example, the government has that $40 in year 1 in either case — in one case, it’s from tax revenue, and in the other, it’s from borrowing. Thus, the only factor is the cost of borrowing, not the return on the cash.

44See supra text accompanying notes 31-32.

45This could also include rents, royalties, and other forms of periodic income from property.

46Or alternatively, there is a lock-in cost to holding assets in a taxable portfolio if the taxpayers avoid rebalancing so as not to trigger gain.

47Galle, supra note 36.

48According to Fidelity’s website, 62 percent of the donations in 2013 were in the form of appreciated securities (available at http://www.fidelitycharitable.org/giving-strategies/tax-estate-planning/appreciated-securities.shtml). It’s unclear what the breakdown is in the remaining 38 percent among cash, real estate, partnership interests, and other forms of property.

49See Treasury, supra note 32, at 61.
or the strategic use of other tax-preferred plans like section 401(k) plans, IRAs, and section 529 plans.

Second, any tax benefit needs to be weighed against other costs of holding assets in a DAF. By some estimates, the tax drag on a typical equity mutual fund is somewhere between 0.27 percent and 1.2 percent.\(^5\) The low end is for the relatively few tax-managed mutual funds, and the high end is for actively managed funds. Equity index funds are in the middle, with a tax drag of around 0.77 percent.\(^2\) But that is awfully close to the 0.6 percent fee that most of the commercial gift funds charge, in addition to the fees for the underlying funds.

Holding an actively managed mutual fund in a DAF may provide better after-tax, after-fee growth than holding that fund outside a DAF, but that is a function of poor tax management by active fund managers. If a well-managed portfolio faces a tax burden more like 0.27 percent — the estimate for tax-managed funds — the donor would be worse off in holding that portfolio or fund in a DAF. In that case, the DAF sponsoring organization captures all the tax benefit from the tax-free growth — and then some. In essence, all taxpayers pay the fee for the simplification and centralization benefits that the DAF provides, with little burden on the donor herself. The tax benefit from having a tax-exempt organization manage the portfolio accrues to the investment managers, not to the donors or charities.

**C. Lumpy Income and Bracket Shifting**

The above sections describe the tax treatment of contributions to a DAF in the typical case, but some of the tax planning of DAFs involves atypical periods of lumpy income. In some of these cases, DAFs may provide an additional tax benefit. A spike in income can have two effects. First, it can push income that would otherwise have been in a lower bracket into a higher bracket. A donation in that year would thus be more valuable. Second, higher income in one year can allow for a higher donation cap under the percentage limitations of section 170(b).

1. **Bracket shifting.** Lumping a donation into a high-bracket year provides a real tax benefit if the assets are not held in the DAF for too long after the contribution. If they are held too long, the tax on the growth in value of the immediate deduction erodes any benefit from the bracket shift. Consider the same $100 gift as above. This year the marginal tax rate that would apply is 40 percent, but next year it is 35 percent. The results are shown in Table 3A.

<table>
<thead>
<tr>
<th>Table 3A. Shifting Brackets — One Year</th>
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</thead>
<tbody>
<tr>
<td><strong>Give to DAF This Year</strong></td>
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<tr>
<td>Y1 starting cash balance</td>
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<tr>
<td>Y1 gift</td>
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<tr>
<td>Value of Y1 tax deduction</td>
</tr>
<tr>
<td>Y2 funds for charity</td>
</tr>
<tr>
<td>Y2 gift to operating charity</td>
</tr>
<tr>
<td>Value of Y2 tax deduction</td>
</tr>
<tr>
<td>Y2 cash balance</td>
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<tr>
<td>Y2 after-tax cash balance</td>
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</tbody>
</table>

The savings thus amount to $4.70, or $4.27 in present value, rather than the $5 that might be expected based on the 5 percent spread in tax rates. And those savings will shrink as the time between the current year and the ultimate disbursement elapses. Consider Table 3B, in which the ultimate distribution is two years, rather than one, after the DAF contribution.

<table>
<thead>
<tr>
<th>Table 3B. Shifting Brackets — Two Years</th>
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<tbody>
<tr>
<td><strong>Give to DAF This Year</strong></td>
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<tr>
<td>Y1 starting cash balance</td>
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<tr>
<td>Y1 gift</td>
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<tr>
<td>Value of Y1 tax deduction</td>
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<td>Value of Y2 tax deduction</td>
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<tr>
<td>Y2 cash balance</td>
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<tr>
<td>Y2 after-tax cash balance</td>
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</tbody>
</table>

Here the savings are $4.37, or just $3.61 in present value. The present value of the pretax savings at the end is always $5, but because the additional tax on the earnings from investing the original $40 deduction also grows — whereas the growth is completed untaxed when giving directly later — the after-tax value of giving early declines the longer the gap between the DAF gift and the ultimate distribution to an operating charity. Indeed,

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\(^5\) See, e.g., Clemens Sialm and Hanjiang Zhang, “Tax-Efficient Asset Management: Evidence From Equity Mutual Funds,” National Bureau of Economic Research working paper 21660 (Apr. 2015), at 34 (also finding that tax-efficient management does not reduce pretax performance); see also James Daniel Bergstresser and James Poterba, “Do After-Tax Returns Affect Mutual Fund Flows?” 63 J. Fin. Econ. 381, 389-390 (2002) (finding tax burdens of between 0.9 percent and 4.7 percent but that during the 1993-1999 period when equity returns were very high, the mean pretax return on equity mutual funds was 19.1 percent).

\(^2\) See Sialm and Zhang, supra note 50.
under these assumptions, the value of giving later exceeds the present value of giving today if the funds are actually distributed to an operating charity 11 years or more after the current period, even if the donor is in the lower bracket in the future.\textsuperscript{52}

This analysis assumes that donors can actually get themselves down a bracket. It’s ultimately an empirical question of how often that occurs, and there appear to be no publicly available data on the characteristics of DAF donors. My assumption, however, is that most of the individuals and couples donating the large amounts that would matter are unlikely to get down a bracket. Of the $182 million in reported deductions for all charitable contributions in 2013 (not just to DAFs), about one-third were from households with AGIs of $500,000 or higher, and of the $48 million in reported noncash contributions, more than half were from households with AGIs of $500,000 or more.\textsuperscript{53} It’s likely that DAF donors skew even more toward those in the highest bracket.

2. Section 170(b) percentage limitations. The other atypical situation in which a DAF may be beneficial is when the donor is otherwise confronting the section 170(b) percentage limitations. This might be because the donor normally has relatively low income but faces a one-time spike and thus has the ability to deduct much more in that year.\textsuperscript{54} If a donor who normally has AGI of $100,000 a year (and thus can take a deduction for only up to $50,000 annually) has one-time income of $1 million, she could give $500,000 in cash that year and get a full deduction.\textsuperscript{55} However, because, as shown in Section III.A, the timing of the deduction doesn’t matter, this would be relevant only when the donor would otherwise face some lifetime giving cap, not merely an annual cap. If the donor wanted to max out her donations every year, giving more in a lumpy year would increase the total lifetime deduction. But if it only accelerated giving that would otherwise occur in later years, there’s no real benefit. Furthermore, there’s nothing special about DAFs in this regard, except as a place to park money in the lumpy years if the donor wanted to smooth contributions over the years — the donor could simply give the larger amounts directly to charity.

More specific to DAFs is that the sponsoring organizations are public charities, and thus donors can give up to 50 percent of their AGI for cash but only 30 percent for capital gain property. In Section III.A, I said that the donor could achieve even better results than a DAF by just investing the property himself. That was assuming the desired asset was capital gain property and that the donor was not facing the 30 percent limitation. But if the donor would like to donate cash exceeding 30 percent of his AGI, he would need to do it immediately. If instead he invested it in a personal portfolio, his donation in future years would be capped at 30 percent rather than 50 percent of AGI, unless he realized any gains in the portfolio. As above, if a wealthy donor wants to maximize lifetime giving, he may be better off donating at least some of that cash to a DAF.\textsuperscript{56} Again, however, this benefit is not unique to a DAF — the donor could get the same result donating directly to an operating charity. Rather, the DAF provides a simplified way to set aside that money when the donor hasn’t decided on ultimate charities or would otherwise like to have relatively smooth giving over the years.

D. Forced Realizations

DAFs also provide some tax benefit when the donor would be forced to realize a gain anyway. Perhaps the donor will be selling stock in an initial public offering or a buyout, the underlying company is redeeming shares, or the donor has to divest itself of particular assets because of government service or a similar conflict of interest. If a donor can meet his charitable goals by donating assets that he would otherwise have to sell, he clearly comes out ahead compared with just giving cash.

That said, he could achieve the same tax benefit by donating directly to operating charities, perhaps in a restricted way to align with his desired distribution schedule. However, if the donor wanted to give to multiple charities over multiple years, doing so with assets that would otherwise be sold this year could be quite complicated. In that case, a DAF may provide some

\textsuperscript{52}Algebraically, suppose that $t_M$ is the higher marginal tax rate that will apply this year, and $t_m$ is the lower marginal rate that will apply in some future year $n$. As before, $r$ is the market growth rate. Taking Equation (2) and discounting it to the present period with discount rate $r$, the present value of the DAF gift today is:

\begin{align}
\frac{t_M C (1 + r)^n - t_m C (1 + r)^n - 1}{(1 + r)^n}
\end{align}

or:

\begin{align}
t_m C \left(1 - t_m \left(1 - \frac{1}{1 + r}\right)^n\right)
\end{align}

By contrast, the present value of giving directly to a charity in year $n$ with the lower marginal rate is:

\begin{align}
t_m C (1 + r)^n
\end{align}

or simply $t_m C$. If we set $t_m = t_m + \gamma$, this becomes $t_M C - \gamma C$. Comparing this to Equation (6), a donor should give to a DAF in the current year when:

\begin{align}
\gamma > t_m C (1 + r)^n - 1
\end{align}

As $n$ and $r$ get bigger, the right side of the inequality gets bigger, so if $n$ and $r$ are high enough, the inequality will no longer hold. Solving for this with $\gamma = 0.05, t_M = 0.4, t_m = 0.2$, and $r = 0.1$ gives us $n < 10.29$. For $n$ larger than that, the donor is better off waiting and donating at time $n$, even though the donor may be in the 35 percent bracket at that time. Different assumptions will of course yield different results.


\textsuperscript{54}This is a version of the common advice to company founders to establish private foundations in the year of the company’s initial public offering.

\textsuperscript{55}Ignoring the issue of bracket shifting, discussed supra.

\textsuperscript{56}To get maximum flexibility, the donor may donate 30 percent of his AGI to a private foundation and the remaining 20 percent to a DAF.
simplification benefit, although at a cost. On the other hand, for some donors, such as small business owners, giving to a DAF also means giving up control. Although the sponsoring organizations market DAFs as mini-private foundations, they are in fact independent entities completely separate from the donors and make no promises about either investment strategy or ultimate distributions. A company founder who hopes to still exert some control while also avoiding capital gain and receiving a deduction should use the private foundation form instead.

E. Donating at Peak Value

Suppose that you plan a deduction for next year, but you believe the market is at a high point this year — so it would make sense to try to use stocks to maximize the value of that deduction this year, even though you plan for the actual gift to be next year. Leaving aside that trying to time the market is a fool’s game, this tactic may generate some tax benefit, but not in the way one might think. Continuing with our same example of a $100 donation this year to a DAF or next year to an operating charity, let’s now assume that the market will drop in value by 10 percent rather than increase.

<table>
<thead>
<tr>
<th>Table 4. Donating at Market Peak</th>
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<tbody>
<tr>
<td>Give to DAF This Year</td>
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<tr>
<td>Y1 starting cash balance</td>
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<tr>
<td>Y1 gift</td>
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<tr>
<td>Value of Y1 tax deduction</td>
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</tr>
<tr>
<td>Y2 cash balance</td>
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<tr>
<td>Y2 after-tax cash balance</td>
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</tbody>
</table>

In both cases, the charity gets $90, so making the donation today does not preserve the value of the contribution, assuming it’s invested in a market portfolio. Further, giving away the asset at peak value doesn’t necessarily lock in a high value for the deduction in present value terms because it still needs to be parked somewhere, and in a market portfolio, it faces the same risk as before. But the donor could get a small tax benefit from realizing the loss from investing the proceeds of the tax deduction, leaving her with more after-tax cash compared with giving directly to the charity next year. The intuition is that by getting the value of the deduction now, she will later be able to realize a tax loss on the value of that deduction, whereas if she held the property and later gave it directly, no losses would be realized. To achieve this result, however, she would have to have some offsetting gains.

The situation is different for a unique asset, rather than a market portfolio. Company founders and executives, for example, may be privy to insider knowledge that the value of their company’s stock will fall in the future. If that company’s stock is not correlated with the market, donating to a DAF today to get the higher deduction value versus waiting may create a real benefit. The deduction would be at its peak value and then would be invested in a market portfolio that could grow even as the original asset declined in value. For example, David Yermack has shown that the chairs and CEOs of public companies tend to make large donations of their company’s stock to their private foundations right before a sharp decline in the company’s share price. But the donor could retain control in the private foundation context; that’s less likely to be the case with a DAF. Thus, the donor would again have to balance the value of getting a higher deduction today with losing control of the underlying asset.

F. Nontax Benefits

DAFs are not without some benefits — they are just not primarily tax benefits. The main advantage of DAFs is that they provide a simple and convenient way to fund contributions to operating charities with appreciated property. For example, if a donor wished to donate to five charities in five equal amounts using appreciated property, she would have to divvy up the property among the five charities (assuming they were even able to receive property). A single donation to Fidelity, followed by advice on how to distribute the proceeds, could be much simpler.

But this means treating the DAF simply as a conduit for the donation of appreciated property — there really would be no fund to speak of. Furthermore, although it might be difficult for a donor to make the five donations of appreciated property herself, for those with investment managers or financial advisers, direct donations may be just as simple as donations to a DAF — they just need to tell their adviser to transfer the appropriate amounts to the charities’ custodial accounts and let him do the math.

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57 Fidelity Charitable’s website states that it will sell any contributed, non-publicly traded assets at its discretion, available at http://www.fidelitycharitable.org/giving-account/what-you-can-donate.shtml.
58 This is just a straight application of Equation (2), when a negative r increases the value of giving to a DAF today rather than giving to an operating charity next year.
59 I’m assuming here that the donor would still have some appreciated gain in the asset even after the drop in value, so she would still prefer to give the asset directly. If, however, she had a high basis, she would instead realize the loss, and the above example wouldn’t apply.
61 See supra Section III.D.
Similarly, DAFs may simplify donations of non-publicly traded assets. Many operating charities, especially smaller ones, are not set up to handle, for example, hedge fund or private equity partnership interests. But the commercial gift funds make very clear that they will take anything. Again, however, this is not a tax-specific issue — presumably large and sophisticated charities would be happy to take the assets directly.

But even if there is some convenience and flexibility from using the DAF as a conduit for gifts of property, what about the fund part? Why use a DAF to set aside assets to fund later contributions? As I've already shown above, there is little tax benefit to establishing a fund, and there is perhaps a tax cost for many donors. I think this fact is not appreciated by most donors. But could there be nontax benefits? In my view, there must be some personal or psychological value to having something with the trappings of a private foundation but without the hassle and with better tax treatment. But that would be based on the fundamental fiction that the DAF remains the donor's. A donor may imagine that the DAF would create a legacy that would, for example, provide some family unity or philanthropic role after the donor's death, much like if the family sat on the board of a private foundation. But in reality, it is a pale imitation with much less control over investment strategy, foundation management, or even charitable distributions. Being able to call a bookkeeping entry at Fidelity Charitable the "John R. Brooks Foundation" may seem nice, but it is ultimately an expensive form of vanity.

IV. Conclusion

Commentary on DAFs generally concludes that they may be a problem for philanthropy. The huge volume of gifts flowing to, and the accumulated assets of, the commercial gift funds imply a lot of money staying on the sidelines rather than supporting the very real charitable needs of society. Furthermore, the more the money stays on the sidelines, the more it gets sucked away as fees for investment managers. The typical reform proposal is to require some minimum payout rate for DAFs to ensure that the contributions to the funds flow out relatively quickly to operating charities. I share those concerns and generally support those proposals.

However, I also find in this report that the concerns about DAFs from a tax policy perspective may be overblown. For most donors most of the time, there is no substantial tax benefit to donating to a DAF, and there may even be a tax cost. Contrary to conventional wisdom, many donors would be better off holding on to the assets they plan to use to fund gifts in future years rather than giving them to a DAF all at once today. Similarly, there is no real revenue loss to the government in present value terms for allowing a full deduction for contributions to a DAF. This may compound the underlying problem with DAFs, however, because the sponsoring organizations are really the only ones that get any real benefit.

This conclusion does not mean that there is no role for tax policy. If a misunderstanding of the tax benefits encourages excessive donations to DAFs and relatively slow payouts to operating charities, the tax law needs to respond. A first step, however, would be to inform potential donors that DAFs are not all that they seem.

(Figures appear on the following pages.)

62 Although, importantly, a decedent's heirs do not necessarily get control. Vanguard Charitable, for example, states that DAFs without a specific succession plan will automatically be transferred to the general fund, which Vanguard Charitable uses at its sole discretion (available at https://www.vanguardcharitable.org/individuals/leave_lega).
Figure 1. DAF Contributions

Contribution (in thousands of dollars)


Schwab
Vanguard
Fidelity

Figure 2. DAF Distributions

Distribution (in thousands of dollars)


Schwab
Vanguard
Fidelity
Figure 3. DAF Total Assets

Figure 4. DAF Annual Return
It’s important to be able to count on someone’s expertise.

(Especially when someone else is counting on yours.)
IRS Letter Rulings

Section 501(c)(3) — Charities

LARGE GRANT TO CHARITY IS UNUSUAL GRANT. The IRS ruled that a large grant from a private trust to a public charity for the construction of a youth facility in an impoverished area and to meet the charity’s operating expenses meets the regulatory criteria of an unusual grant.

Full Text Citations: LTR 201608016; Doc 2016-3578; 2016 TNT 34-16

IRS REVOCKES ORGANIZATION’S EXEMPT STATUS. The IRS revoked the section 501(c)(3) tax-exempt status of an organization that failed to establish that it operated exclusively for exempt purposes and ruled that its operations further the private interest of its financial backers.

Full Text Citations: LTR 201609006; Doc 2016-4090; 2016 TNT 39-30

INACTIVE ORGANIZATION LOSES EXEMPTION. The IRS revoked the tax-exempt status of an organization that has been inactive for several years and therefore did not meet the operational requirements for continued exemption.

Full Text Citations: LTR 201609007; Doc 2016-4091; 2016 TNT 39-31

IRS REVOCKES ORGANIZATION’S EXEMPT STATUS. The IRS revoked the section 501(c)(3) exempt status of an organization because it benefited the private interests of its founders and therefore did not operate exclusively for exempt purposes.

Full Text Citations: LTR 201610002; Doc 2016-4641; 2016 TNT 44-42

IRS REVOCKES ORGANIZATION’S EXEMPT STATUS. The IRS revoked the section 501(c)(3) exempt status of an organization because it benefited private interests and therefore did not operate exclusively for exempt purposes.

Full Text Citations: LTR 201610026; Doc 2016-4642; 2016 TNT 44-43

IRS REVOCKES INACTIVE ORGANIZATION’S EXEMPT STATUS. The IRS revoked the section 501(c)(3) status of an inactive organization, finding that it failed to meet the operational requirements for continued exemption.

Full Text Citations: LTR 201611019; Doc 2016-5236; 2016 TNT 49-23

Section 501(c)(7) — Clubs

IRS REVOCKES SOCIAL CLUB’S EXEMPTION. The IRS revoked the section 501(c)(7) exempt status of a social club whose activities included trap shooting because the club’s nonmember income exceeded 15 percent of its total gross receipts and its selling of calendars and offering use of its facilities to the general public showed the club was engaged in a business.

Full Text Citations: LTR 201612014; Doc 2016-5845; 2016 TNT 54-27

Section 501(c)(15) — Insurance Companies

ORGANIZATION FAILED TO QUALIFY AS EXEMPT INSURER. The IRS ruled that an organization was not an insurance company for federal income tax purposes and therefore failed to meet the requirements of section 501(c)(15) to qualify as an exempt organization.

Full Text Citations: LTR 201609008; Doc 2016-4092; 2016 TNT 39-29

Section 642 — Trust Tax Rules

TRUST ENTITLED TO CHARITABLE CONTRIBUTION DE- DUCTION. The IRS ruled that a trust is entitled to a section 642(c)(1) charitable contribution deduction equal to the amount of income in respect of a decedent that it received from an IRA distribution, provided the trust pays the entire lump sum distribution to a specified section 170(c) foundation.

Full Text Citations: LTR 201611002; Doc 2016-5219; 2016 TNT 49-24

Section 4941 — Foundation Self-Dealing

FOUNDATION’S ASSET TRANSFERS NOT SELF-DEALING. The IRS issued nine rulings on the proposed transfers of 40 percent of a private foundation’s assets to newly created foundations, including that the transaction will further the foundation’s section 501(c)(3) purposes, it won’t give rise to gross investment income, and it won’t constitute any acts of self-dealing.

Full Text Citations: LTR 201609001; Doc 2016-4085; 2016 TNT 39-28

Section 4945 — Taxable Expenditures

SCHOLARSHIP AWARDS WILL NOT BE TAXABLE. The IRS ruled that expenditures made under a program that awards scholarships to an employer’s eligible employees will not be taxable and that the awards will not be taxable to the recipients if used for qualified tuition and related expenses.

Full Text Citations: LTR 201608017; Doc 2016-3579; 2016 TNT 34-25
IRS approves foundation's educational grant procedures. The IRS approved a private foundation’s procedures for awarding educational grants and ruled that expenditures made under those procedures won’t be taxable.

Full Text Citations: LTR 201608018; Doc 2016-3580; 2016 TNT 34-26

Scholarship awards won’t be taxable. The IRS ruled that expenditures made through a private foundation’s scholarship program will not be taxable and that the awards will not be taxable to the recipients if used for qualified tuition and related expenses.

Full Text Citations: LTR 201608019; Doc 2016-3581; 2016 TNT 34-27

Scholarship awards will not be taxable. The IRS ruled that expenditures made under a program that awards scholarships to the children of a company’s employees will not be taxable and that the awards will not be taxable to the recipients if used for qualified tuition and related expenses.

Full Text Citations: LTR 201608020; Doc 2016-3582; 2016 TNT 34-28

Foundation’s procedures for awarding scholarships approved. The IRS approved a private foundation’s procedures for awarding scholarships and ruled that expenditures made under those procedures won’t be taxable and that the awards aren’t taxable to the recipients if used for qualified tuition and related expenses.

Full Text Citations: LTR 201609009; Doc 2016-4093; 2016 TNT 39-34

Foundation’s educational grants aren’t taxable expenditures. The IRS approved a private foundation’s procedures for awarding educational grants to facilitate the introduction of international art professionals and ruled that expenditures made under those procedures won’t be taxable.

Full Text Citations: LTR 201612015; Doc 2016-5846; 2016 TNT 54-26

Section 170 — Charitable Deduction

Contribution of coin collection requires qualified appraisal. In emailed advice, the IRS explained that a qualified appraisal is required under section 170(f)(11) when coins with a claimed value exceeding $5,000 are contributed, and that the “readily valued property” cash exception does not apply to coins unless the claimed value does not exceed their face value and the coins are acceptable as legal tender.

Full Text Citations: ECC 201608012; Doc 2016-3574; 2016 TNT 34-32
IRS News

IRS PUBLISHES PROPOSED REGS DEFINING POLITICAL SUBDIVISION. The IRS has published proposed regulations clarifying the definition of political subdivision for purposes of tax-exempt bonds.


IRS AMENDS APPLICABILITY DATES OF POLITICAL SUBDIVISION REGS. The IRS has corrected proposed regulations on the definition of political subdivision for purposes of tax-exempt bonds, amending the applicability dates of the proposed definition to provide transition rules for bonds issued before the general applicability date and some refunding bonds.

Full Text Citations: Doc 2016-5078; 2016 TNT 47-10; reprinted on p. 304.

IRS Tax Correspondence

Section 501(c)(4) — Civic Leagues, etc.

WATCHDOGS BLAST IRS FOR OVERRULING STAFF ON CROSSROADS EXEMPTION. The IRS decision to overrule the conclusions of its staff and grant tax-exempt status to Crossroads GPS despite the organization’s substantial involvement in political activities “represents a fundamental failure by the IRS to rationally and properly administer the tax laws,” according to the Campaign Legal Center and Democracy 21.

Full Text Citations: Doc 2016-4571; 2016 TNT 43-16

NRA FAILED TO DISCLOSE $60 MILLION IN SPENDING, CREW SAYS. The IRS should conduct an examination of the National Rifle Association because further investigations of the NRA indicate it failed to disclose $60 million in political spending in violation of its tax-exempt status, Citizens for Responsibility and Ethics in Washington said in a March 8 letter to the IRS.

Full Text Citations: Doc 2016-4903; 2016 TNT 46-24

Internal Revenue Bulletin

Section 170 — Charitable Deduction

ORGANIZATIONS LOSE CHARITABLE DONEE STATUS. The IRS has listed organizations that no longer qualify as charitable donees under sections 501(c)(3) and 170(c)(2).

Full Text Citations: Doc 2016-4072; 2016 TNT 39-17

Section 501(c)(3) — Charities

IRS LISTS ORGANIZATION NO LONGER RECOGNIZED AS TAX EXEMPT. The IRS has advised donors that on October 13, 2015, the Tax Court determined that a particular organization is not qualified as an organization described in section 501(c)(3), is not exempt from taxation under section 501(a), and is not an organization described in section 170(c)(2).

Full Text Citations: Doc 2016-3558; 2016 TNT 34-9

IRS LISTS ORGANIZATION NO LONGER RECOGNIZED AS TAX-EXEMPT. The IRS advised donors that on November 4, 2015, the Tax Court determined that a particular organization is not recognized as an organization described in section 501(c)(3), is not exempt from taxation under section 501(a), and is not an organization described in section 170(c)(2).

Full Text Citations: Doc 2016-4071; 2016 TNT 39-19

For more Exempt Organization Tax Review content, please visit www.taxnotes.com.
IRS LISTS ORGANIZATION THAT IS RECOGNIZED AS TAX EXEMPT. The IRS has listed an organization for which the Tax Court has entered a stipulation that it is qualified as tax exempt under section 501(c)(3) and (a) for tax years beginning July 1, 2001.

Full Text Citations: Doc 2016-4678; 2016 TNT 44-31

Section 7428 — Sec. 501 Declaratory Judgments

IRS LISTS GROUPS CHALLENGING REVOCA TION OF ELIGIBLE DONEE STATUS. The IRS, noting that the protections of section 7428(c) apply, has listed organizations that are challenging the revocation of their status as eligible donees under section 170(c)(2).

Full Text Citations: Doc 2016-3557; 2016 TNT 34-8

IRS LISTS GROUP CHALLENGING REVOCA TION OF ELIGIBLE DONEE STATUS. The IRS, noting that the protections of section 7428(c) apply, has listed an organization that is challenging the revocation of its status as an eligible donee under section 170(c)(2).


Miscellaneous

IRS SEEKS RECOMMENDATIONS FOR 2016-2017 PRIORITY GUIDANCE PLAN. The IRS has asked the public to suggest items for its priority guidance plan for 2016-2017.

Full Text Citations: Doc 2016-5876; 2016 TNT 54-17

IRS Publications

Section 501(c)(3) — Charities

IRS RELEASES PUBLICATION ON CHARITABLE CONTRIBUTIONS. The IRS has released Publication 1771 (rev. Mar. 2016), Charitable Contributions — Substantiation and Disclosure Requirements, which explains general rules and specifications for documenting charitable deductions and explains new guidelines that allow charities to electronically mail documentation to donors.

Full Text Citations: Doc 2016-4885; 2016 TNT 46-49

Other IRS Documents

Section 170 — Charitable Deduction

IRS RENEWS ART ADVISORY PANEL. The IRS has extended the charter for its Art Advisory Panel for two years.

Full Text Citations: Doc 2016-3505; 2016 TNT 33-15

Section 501 — Tax-Exempt Organizations

MEMO UPDATES PROCEDURES ON EXEMPT ORG REVOCA TIONS AFTER PATH ACT. The IRS Tax-Exempt and Government Entities Division has issued a memorandum on revised procedures regarding revocations and modifications of exempt status as a result of the enactment of the Protecting Americans from Tax Hikes Act of 2015 (PATH Act).

Full Text Citations: Doc 2016-4419; 2016 TNT 42-27

PROCEDURES REVISED FOR EXEMPT ORG ADVERSE DE TERRMINATION CASES. The IRS has revised procedures followed by EO Determinations Quality Assurance for protested and appealed adverse determination cases.

Full Text Citations: Doc 2016-4870; 2016 TNT 46-31

Section 7526 — Low-Income Taxpayer Clinics

LOW-INCOME TAXPAYER CLINIC GRANT APPLICATION AVAILABLE. The IRS has announced that it is accepting applications for Low-Income Taxpayer Clinic supplemental grants; the IRS will award up to $1.28 million in matching funds to qualifying organizations, and the applications are due by April 1, 2016.

Full Text Citations: Doc 2016-4560; 2016 TNT 43-34

Miscellaneous

IRS RELEASES CONCEPT OF FUTURE OPERATIONS FOR TE/GE. The IRS Tax-Exempt/Government Entities Division concept of operations, dated December 31, 2014, outlines the division’s five-year plan to “optimize its business operations and increase TE/GE taxpayer compliance.”

Full Text Citations: Doc 2016-3295; 2016 TNT 34-42
IRS News Releases

Section 7526 — Low-Income Taxpayer Clinics

IRS ANNOUNCES DEADLINE FOR PART-YEAR LITC GRANT APPLICATIONS. The IRS has announced that it will accept applications from March 1 to April 1 for a part-year low-income taxpayer clinic (LITC) matching grant from qualified organizations in some identified geographic areas.

Full Text Citations: Doc 2016-3906; 2016 TNT 37-11

Treasury Tax Correspondence

Section 529A — Qualified ABLE Programs

ADMINISTRATOR SEEKS TRANSITION RELIEF FOR SOME ABLE PROGRAMS. Duane Ottenstroer of Florida ABLE Inc. has asked that Treasury and the IRS provide transition relief for qualified Achieving a Better Life Experience programs that launch within the six-month period following the issuance of final regulations under section 529A.

Full Text Citations: Doc 2016-5476; 2016 TNT 51-24

Full Text Guidance

IRS Publishes Proposed Regs Defining Political Subdivision

REG-129067-15; 2016-10 IRB 421

The IRS has published proposed regulations clarifying the definition of political subdivision for purposes of tax-exempt bonds.

[4830-01-p]

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 1

[REG-129067-15]

RIN 1545-BM99

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document contains proposed regulations that provide guidance regarding the definition of political subdivision for purposes of tax-exempt bonds. The proposed regulations are necessary to specify the elements of a political subdivision. The proposed regulations will affect State and local governments that issue tax-exempt bonds and users of property financed with tax-exempt bonds. Under certain transition rules, however, the proposed definition of political subdivision will not apply for determining whether outstanding bonds are obligations of a political subdivision and will not apply to existing entities for a transition period. This document also provides a notice of a public hearing for these proposed regulations.

DATES: Written or electronic comments must be received by May 23, 2016. Request to speak and outlines of topics to be discussed at the public hearing scheduled for June 6, 2016, at 10:00 a.m., must be received by May 23, 2016.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG-129067-15), Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered to: CC:PA:LPD:PR Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (REG-129067-15), Courier’s Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC, or sent electronically via the Federal eRulemaking Portal at www.regulations.gov (REG-129067-15). The public hearing will be held at the Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Spence Hanemann at (202) 317-6980; concerning submissions of comments and

Editor’s Note: Full text documents are reprinted exactly as they were received from the issuing agency.
the hearing, Oluwafunmilayo (Funmi) Taylor at (202) 317-6901 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

This document contains proposed amendments to 26 CFR part 1 under section 103 of the Internal Revenue Code (Code). Section 103 generally provides that, with certain exceptions, gross income does not include interest on any obligation of a State or political subdivision thereof. Section 1.103-1 of the Income Tax Regulations (the Existing Regulations) defines political subdivision as "any division of any State or local governmental unit which is a municipal corporation or which has been delegated the right to exercise part of the sovereign power of the unit."

On a few occasions, Federal courts have ruled on whether an entity qualifies as a political subdivision. E.g., Philadelphia Nat'l Bank v. United States, 666 F.2d 834 (3d Cir. 1981); Comm'r of Internal Revenue v. White's Estate, 144 F.2d 1019 (2d Cir. 1944). The IRS has also addressed this issue in revenue rulings, most recently in 1983. E.g., Rev. Rul. 83-131 (1983-2 CB 184); Rev. Rul. 78-138 (1978-1 CB 314). Because the results in these revenue rulings generally turn on the unique facts and circumstances of the individual cases, numerous entities have sought and received letter rulings on whether they are political subdivisions. Letter rulings, however, are limited to their particular facts, may not be relied upon by taxpayers other than the taxpayer that received the ruling, and are not a substitute for published guidance. See 26 U.S.C. 6110(k)(3) (2015) (providing generally that a ruling, determination letter, or technical advice memorandum may not be used or cited as precedent).

Commenters have requested additional published guidance, to be applied prospectively, on which facts and circumstances are germane to an entity's status as a political subdivision. The Treasury Department and IRS recognize the need to clarify the definition of political subdivision to provide greater certainty to prospective issuers and to promote greater consistency in how the definition is applied across a wide range of factual situations. These proposed regulations (the Proposed Regulations) would provide a new definition of political subdivision for purposes of tax-exempt bonds and would update and streamline other portions of the Existing Regulations. The definition of political subdivision in the Proposed Regulations does not apply in determining whether an entity is treated as a political subdivision of a State for purposes of section 414(d) of the Code.

Explanation of Provisions

1. Definition of Political Subdivision

The Proposed Regulations clarify and further develop the eligibility requirements for a political subdivision. To qualify as a political subdivision under the Proposed Regulations, an entity must meet three requirements, taking into account all of the facts and circumstances: sovereign powers, governmental purpose, and governmental control. The Proposed Regulations also authorize the Commissioner to set forth in future guidance to be published in the Internal Revenue Bulletin additional circumstances in which an entity qualifies as a political subdivision.

A. Sovereign Powers

The Proposed Regulations continue, without substantive change, the longstanding requirement that a political subdivision be empowered to exercise at least one of the generally recognized sovereign powers. The three sovereign powers recognized for this purpose are eminent domain, police power, and taxing power. See Comm'r of Internal Revenue v. Shamberg's Estate, 144 F.2d 998 (2d Cir. 1944). The entity must be able to exercise a substantial amount of at least one of these powers. See, e.g., Rev. Rul. 77-164 (1977-1 CB 20); Rev. Rul. 77-165 (1977-1 CB 21).

B. Governmental Purpose

In determining whether an entity is a political subdivision, the case law and administrative guidance interpreting the definition of political subdivision in the Existing Regulations commonly consider whether the entity serves a public purpose. Historically, the determination of whether an entity serves a public purpose has focused on the purpose for which the entity was created, usually as set forth in the legislation authorizing creation of the entity, rather than on the entity's conduct after its creation. See, e.g., Shamberg's Estate, 144 F.2d at 1004. The Proposed Regulations require that a political subdivision serve a governmental purpose. A governmental purpose requires, among other things, that the purpose for which the entity was created, as set out in its enabling legislation, be a public purpose and that the entity actually serve that purpose. It also requires that the entity operate in a manner that provides a significant public benefit with no more than incidental benefit to private persons. Cf, Rev. Rul. 90-74 (1990-2 CB 34) (applying an "incidental private benefit" standard for purposes of determining whether income is included in gross income under section 115(1)).

C. Governmental Control

The Proposed Regulations provide that a political subdivision must be governmentally controlled. The Proposed Regulations provide rules for determining both what constitutes control and which parties must possess that control.

i. Definition of Control

The Proposed Regulations define control to mean ongoing rights or powers to direct significant actions of the entity. Rights or powers to direct the entity's actions only at a particular point in time are not ongoing and, therefore, do not constitute control. For example, the right to approve the entity's plan of operation as a condition of the entity's formation is not an ongoing right. To constitute control, a collection of rights and powers must enable its holder to direct the significant actions of the entity.

The Proposed Regulations provide three non-exclusive benchmarks of rights or powers that constitute control: (1) the right or power both to approve and to remove a majority of an entity's governing body; (2) the right or power to elect a majority of the governing body of the entity in periodic elections of reasonable frequency;
or (3) the right or power to approve or direct the significant uses of funds or assets of the entity in advance of their use. Aside from these three arrangements, the determination of whether a collection of rights and powers constitutes control will depend on the facts and circumstances. Neither the right to dissolve an entity nor procedures designed to ensure the integrity of the entity but not to direct significant actions of the entity are control. Cf., Rev. Rul. 69-453 (1969-2 CB 182) (addressing procedures that do not constitute control in the context of instrumentalities).

ii. Control Vested in a State or Local Governmental Unit or an Electorate

Control by a small faction of private individuals, business corporations, trusts, partnerships, or other persons is fundamentally not governmental control. Therefore, the Proposed Regulations generally require that control be vested in either a general purpose State or local governmental unit or in an electorate established under an applicable State or local law of general application. If, however, a small faction of private persons controls an electorate, that electorate’s control of the entity does not constitute governmental control of the entity. Accordingly, the Proposed Regulations provide that an entity controlled by an electorate is not governmental control when the outcome of the exercise of control is determined solely by the votes of an unreasonably small number of private persons.

The determination of whether the number of private persons controlling an electorate is unreasonably small generally depends on all of the facts and circumstances. To provide certainty, the Proposed Regulations limit application of this facts and circumstances test to situations that fall between two quantitative measures of concentration in voting power. The number of private persons controlling an electorate is always unreasonably small if the combined votes of the three voters with the largest shares of votes in the electorate will determine the outcome of the relevant election, regardless of how the other voters vote. The number of private persons controlling an electorate is never unreasonably small if determining the outcome of the relevant election requires the combined votes of more voters than the 10 voters with the largest shares of votes in the electorate. For example, control can always be vested in an electorate comprised of 20 or more voters that each have the right to cast one vote in the relevant election without giving rise to a private faction. For purposes of applying these measures of concentration in voting power, related parties are treated as a single voter and the votes of the related parties are aggregated.

iii. Possible Relief for Development Districts

Some observers have suggested that, despite private control, development districts should be political subdivisions during an initial development period in which one or two private developers elect the district’s governing body and no other governmental control exists. The Treasury Department and IRS recognize that the governmental control requirement may present challenges for such development districts. In these circumstances, the Treasury Department and IRS are concerned about the potential for excessive private control by individual developers, the attendant impact of excessive issuance of tax-exempt bonds, and inappropriate private benefits from this Federal subsidy. The Treasury Department and IRS seek public comment on whether it is necessary or appropriate to permit such districts to be political subdivisions during an initial development period; how such relief might be structured; what specific safeguards might be included in the recommended relief to protect against potential abuse; and whether the proposed prospective effective dates and transition periods in § 1.103-1(d) of the Proposed Regulations provide sufficient relief.

2. Streamlining Amendments

In addition to amending the definition of political subdivision, paragraphs (a) and (b) of the Proposed Regulations update the references in the general provisions of the Existing Regulations to reflect changes to the Code made in the Tax Reform Act of 1986, Public Law 99-514, 100 Stat. 2085, and other laws and regulations since the promulgation of the longstanding Existing Regulations. The Proposed Regulations also streamline these provisions. In general, the Treasury Department and the IRS intend that these proposed amendments not change the meaning of the Existing Regulations. The last sentence of § 1.103-1(a) of the Proposed Regulations, however, clarifies that the continued tax-exemption of an issue of bonds depends on its issuer’s continued status as a qualifying issuer of tax-exempt bonds. The Treasury Department and IRS seek comments on the need for remedial action provisions in the event the entity ceases to qualify as a political subdivision and on the substance of any such provisions.

3. Applicability Dates and Reliance on Proposed Regulations

Subject to certain transition rules, the Proposed Regulations generally would apply to all entities for all purposes of the tax-exempt bond provisions of sections 103 and 141 to 150 beginning 90 days after the Proposed Regulations are finalized. In order to ease hardship that may arise from the new definition of political subdivision, under proposed transition rules, that definition would not apply for purposes of determining whether outstanding bonds and refunding bonds in which the weighted average maturity is not extended continue to be obligations of a political subdivision. While these transition rules for outstanding bonds and refunding bonds would apply for the purpose of determining whether these bonds continue to be obligations of a political subdivision, the new proposed definition of political subdivision would apply for other purposes under sections 103 and 141 to 150, such as whether a new entity that subsequently became a user of a project financed with such bonds qualified as a State or local governmental unit for purposes of section 141. Furthermore, under another proposed transition rule that would apply to entities in existence prior to 30 days after the Proposed Regulations are published, the proposed definition of political subdivision would not apply for any purpose until three years and ninety days after the Proposed Regulations are finalized. This three-year transition period provides existing entities an opportunity to...
restructure as necessary to satisfy the new definition of political subdivision and allows existing entities to continue to issue new bonds during the transition period. To enhance certainty, an issuer also may choose to apply the definition of political subdivision in § 1.103-1(c) of the Proposed Regulations in whole, but not in part, for any purpose of sections 103 and 141 through 150, provided such use is applied consistently for all purposes of sections 103 and 141 through 150 to any given entity.

Special Analyses

Certain IRS regulations, including this one, are exempt from the requirements of Executive Order 12866, as supplemented and reaffirmed by Executive Order 13563. Therefore, a regulatory impact assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because these regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Code, this notice of proposed rulemaking has been submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small entities.

Comments and Public Hearing

Before these Proposed Regulations are adopted as final regulations, consideration will be given to any comments that are submitted timely to the IRS as prescribed in this preamble under the “Addresses” heading. The Treasury Department and the IRS request comments on all aspects of the proposed rules. All comments will be available at www.regulations.gov or upon request.

A public hearing has been scheduled for June 6, 2016, at 10:00 a.m., in the Auditorium of the Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC. Due to building security procedures, visitors must enter at the Constitution Avenue entrance. In addition, all visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 30 minutes before the hearing starts. For more information about having your name placed on the building access list to attend the hearing, see the “FOR FURTHER INFORMATION CONTACT” section of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments at the hearing must submit an outline of the topics to be discussed and the time to be devoted to each topic by May 23, 2016. Submit a signed paper or electronic copy of the outline as prescribed in this preamble under the “Addresses” heading. A period of 10 minutes will be allotted to each person for making comments. An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal authors of these regulations are Spence Hanemann and Timothy Jones, Office of Associate Chief Counsel (Financial Institutions and Products), IRS. However, other personnel from the IRS and the Treasury Department participated in their development.

Availability of IRS Documents


List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1 — INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 **

Par. 2. Section 1.103-1 is revised to read as follows:

§ 1.103-1 Interest on State or local bonds.

(a) Interest on State or local bonds. Under section 103(a), except as otherwise provided in section 103(b), gross income does not include interest on any State or local bond. Under section 103(c), the term State or local bond means any obligation (as defined in § 1.1150-1(b)) of a State (including for this purpose the District of Columbia or any possession of the United States) or a political subdivision thereof (a State or local governmental unit). Obligations issued by or on behalf of any State or local governmental unit by a constituted authority empowered to issue such obligations are the obligations of such a unit. An obligation qualifies as a State or local bond so long as the issuer of that obligation remains a State or local governmental unit or a constituted authority.

(b) Certain limitations on interest exclusion. Under section 103(b), the interest exclusion in section 103(a) is inapplicable to a private activity bond under section 141(a) (unless the bond is a qualified bond under section 141(e)), an arbitrage bond under section 148, or a bond which does not meet the applicable requirements of section 149.

(c) Definition of political subdivision — (1) In general. The term political subdivision means an entity that meets each of the requirements of paragraphs (c)(2) (sovereign powers), (c)(3) (governmental purpose), and (c)(4) (governmental control) of this section, taking into account all of the facts and circumstances, or that is described in published guidance issued pursuant to paragraph (c)(5) of this section. Entities that may qualify as political
subdivisions include, among others, general purpose governmental entities, such as cities and counties (whether or not incorporated as municipal corporations), and special purpose governmental entities, such as special assessment districts that provide for roads, water, sewer, gas, light, reclamation, drainage, irrigation, levee, school, harbor, port improvements, and other governmental purposes for a State or local governmental unit.

(2) Sovereign powers. Pursuant to a State or local law of general application, the entity has a delegated right to exercise a substantial amount of at least one of the following recognized sovereign powers of a State or local governmental unit: the power of taxation, the power of eminent domain, and police power.

(3) Governmental purpose. The entity serves a governmental purpose. The determination of whether an entity serves a governmental purpose is based on, among other things, whether the entity carries out the public purposes that are set forth in the entity’s enabling legislation and whether the entity operates in a manner that provides a significant public benefit with no more than incidental private benefit.

(4) Governmental control. A State or local governmental unit exercises control over the entity. For this purpose, control is defined in paragraph (c)(4)(i) of this section and a State or local governmental unit exercises such control only if the control is vested in persons described in paragraph (c)(4)(ii) of this section.

(i) Definition of control. Control means an ongoing right or power to direct significant actions of the entity. Rights or powers may establish control either individually or in the aggregate. Among rights or powers that may establish control, an ongoing ability to exercise one or more of the following significant rights or powers, on a discretionary and non-ministerial basis, constitutes control: the right or power both to approve and to remove a majority of the governing body of the entity; the right or power to elect a majority of the governing body of the entity in periodic elections of reasonable frequency; or the right or power to approve or direct the significant uses of funds or assets of the entity in advance of that use. Procedures designed to ensure the integrity of the entity but not to direct significant actions of the entity are insufficient to constitute control of an entity. Examples of such procedures include requirements for submission of audited financial statements of the entity to a higher level State or local governmental unit, open meeting requirements, and conflicts of interest limitations.

(ii) Control vested in a State or local governmental unit or an electorate. Control is vested in persons described in paragraphs (c)(4)(i)(A) or (c)(4)(i)(B) of this section or a combination thereof:

(A) A State or local governmental unit possessing a substantial amount of each of the sovereign powers and acting through its governing body or through its duly authorized elected or appointed officials in their official capacities; or

(B) An electorate established under applicable State or local law of general application, provided the electorate is not a private faction (as defined in paragraph (c)(4)(iii) of this section).

(iii) Definition of private faction — (A) In general. A private faction is any electorate if the outcome of the exercise of control described in paragraph (c)(4)(i) of this section is determined solely by the votes of an unreasonably small number of private persons. The determination of whether a number of such private persons is unreasonably small depends on all of the facts and circumstances, including, without limitation, the entity’s governmental purpose; the number of members in the electorate; the relationships of the members of the electorate to one another, the manner of apportionment of votes within the electorate; and the extent to which the members of the electorate adequately represent the interests of persons reasonably affected by the entity’s actions.

For purposes of this definition, the special rules in paragraphs (c)(4)(iii)(B) through (D) of this section apply.

(B) Treatment of certain limited electorates as private factions. An electorate is a private faction if any three private persons that are members of the electorate possess, in the aggregate, a majority of the votes necessary to determine the outcome of the relevant exercise of control.

(C) Safe harbor — voting power dispersed among more than 10 persons. An electorate is not a private faction if the smallest number of private persons who can combine votes to establish a majority of the votes necessary to determine the outcome of the relevant exercise of control is greater than 10 persons. For example, if an electorate consists of 20 private persons with equal, five-percent shares of the total votes, then that electorate is a private faction because a minimum of 11 members of that electorate is necessary to have a majority of the votes. In contrast, if an electorate consists of 10 private persons with unequal voting shares in which some combination of 10 or fewer members has a majority of the votes, then that electorate does not qualify for the safe harbor from treatment as a private faction under this paragraph (c)(4)(iii)(C).

(D) Operating rules. The following rules apply for purposes of determining numbers of voters and voting control in paragraphs (c)(4)(iii)(B) and (C) of this section:

(1) Related parties (as defined in § 1.150-1(b)) are treated as a single person; and

(2) In computing the number of votes necessary to determine the outcome of the relevant exercise of control, all voters entitled to vote in an election are assumed to cast all votes to which they are entitled.

(5) Authority of the Commissioner. In guidance published in the Internal Revenue Bulletin, the Commissioner may set forth additional circumstances in which an entity qualifies as a political subdivision of a State or local governmental unit. See § 601.601(d)(2)(ii) of this chapter.

(d) Applicability dates — (1) In general. Except as otherwise provided in paragraphs (d)(2) through (4) of this section, this section applies to all entities for all purposes of sections 103 and 141 through 150 beginning on the date 90 days after the publication of the Treasury decision adopting these rules as final regulations in the Federal Register.

(2) Applicability date of the definition of political subdivision for outstanding bonds. For purposes of determining whether outstanding bonds of an entity are obligations of a political subdivision under section 103, the definition of political subdivision in paragraph (c) of this section does not apply to that entity with respect to its outstanding
bonds that are issued before the general applicability date under paragraph (d)(1) of this section.

(3) Applicability date of the definition of political subdivision for refunding bonds. For purposes of determining whether refunding bonds of an entity are obligations of a political subdivision under section 103, the definition of political subdivision in paragraph (c) of this section does not apply to that entity with respect to its refunding bonds that are issued on or after the general applicability date under paragraph (d)(1) of this section to refund bonds with respect to which paragraph (c) of this section otherwise does not apply, provided that the weighted average maturity of the refunding bonds is no longer than the remaining weighted average maturity of the refunded bonds.

(4) Applicability date of the definition of political subdivision for existing entities. For existing entities that are created or organized before March 24, 2016, the definition of political subdivision in paragraph (c) of this section does not apply for any purpose of sections 103 and 141 to 150 during the three-year period beginning on the general applicability date under paragraph (d)(1) of this section.

(5) Elective application of definition of political subdivision. An issuer may choose to apply the definition of political subdivision in paragraph (c) of this section to an issue of bonds in circumstances in which that section otherwise would not apply to that issue under paragraph (d)(2) or (3) of this section, provided that choice is applied consistently to the issue. An entity may choose to apply the definition of political subdivision in paragraph (c) of this section to an entity in circumstances in which that section otherwise would not apply to that entity under paragraph (d)(4) of this section, provided that choice is applied consistently to the entity.

John Dalrymple
Deputy Commissioner for Services and Enforcement.

[FR Doc. 2016-03790 Filed: 2/22/2016; 8:45 am; Publication Date: 2/23/2016]

IRS Amends Applicability Dates of Political Subdivision Regs

REG-129067-15

The IRS has corrected proposed regulations on the definition of political subdivision for purposes of tax-exempt bonds, amending the applicability dates of the proposed definition to provide transition rules for bonds issued before the general applicability date and some refunding bonds.

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 1
[REG-129067-15]
RIN 1545-BM99

Definition of Political Subdivision; Correction

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Correction to notice of proposed rulemaking.

SUMMARY: This document contains corrections to a notice of proposed rulemaking and notice of public hearing (REG-129067-15) published in the Federal Register on Tuesday, February 23, 2016, (81 FR 8870) that specifies the elements of a political subdivision for purposes of tax-exempt bonds. The corrections amend the applicability dates of the proposed definition of political subdivision to provide transition rules with respect to bonds issued before the general applicability date and certain refunding bonds.

DATES: Written or electronic comments for the notice of proposed rulemaking and notice of public hearing published at 81 FR 8870, February 23, 2016, are still being accepted and must be received by May 23, 2016. Request to speak and outlines of topics to be discussed at the public hearing scheduled for June 6, 2016, at 10:00 a.m., are also still being accepted and must be received by May 23, 2016.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG-129067-15), Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered to: CC:PA:LPD:PR Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (REG-129067-15), Courier’s Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC, 20224 or sent electronically via the Federal eRulemaking Portal at www.regulations.gov (REG-129067-15). The public hearing will be held at the Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the correction to the proposed regulations, Spence Hanemann at (202) 317-6980; concerning submissions of comments and the hearing, Oluwafunmilayo (Funmi) Taylor at (202) 317-6901 (not toll-free numbers).
SUPPLEMENTARY INFORMATION:

Background

The notice of proposed rulemaking and notice of public hearing that is the subject of this correction is under section 103 of the Internal Revenue Code.

Need for Correction

As published in the Federal Register (81 FR 8870, February 23, 2016), § 1.103-1(c) of the notice of proposed rulemaking and notice of public hearing proposes a new definition of political subdivision. Section 1.103-1(d)(1) provides that, except as otherwise provided in §§ 1.103-1(d)(2) through (4), § 1.103-1 (including § 1.103-1(c)) applies to all entities for all purposes of sections 103 and 141 through 150 beginning on the date 90 days after the publication of the Treasury decision adopting the rules as final regulations in the Federal Register. Section 1.103-1(d)(2) provides that, for purposes of determining whether bonds are obligations of a political subdivision under section 103, the definition of political subdivision in § 1.103-1(c) does not apply to an entity with respect to bonds that are issued before the general applicability date under § 1.103-1(d)(1). Section 1.103-1(d)(3) provides that, for purposes of determining whether refunding bonds of an entity are obligations of a political subdivision under section 103, the definition of political subdivision in § 1.103-1(c) does not apply to an entity with respect to refunding bonds that are issued on or after the general applicability date under § 1.103-1(d)(1) to refund bonds with respect to which § 1.103-1(c) otherwise does not apply, provided the weighted average maturity of the refunding bonds is no longer than the remaining weighted average maturity of the refunded bonds. Section 1.103-1(d)(4) provides that, for existing entities that are created or organized before March 24, 2016, the definition of political subdivision in § 1.103-1(c) does not apply for any purpose of sections 103 and 141 through 150 during the three-year period beginning on the general applicability date under § 1.103-1(d)(1).

After publication of the notice of proposed rulemaking and notice of public hearing in the Federal Register (81 FR 8870, February 23, 2016), the Treasury Department and the IRS received comments requesting that the transition rule in § 1.103-1(d)(2) be applied not only for purposes of determining whether bonds are the obligations of a political subdivision under section 103 but also for all other purposes of sections 103 and 141 through 150, including the private activity bond rules. This document also amends the transition rule for refunding bonds in § 1.103-1(d)(3) to provide relief consistent with that provided in § 1.103-1(d)(2), as amended. The effect of the amendment to § 1.103-1(d)(2) is that the proposed definition of political subdivision will not apply for any purpose under sections 103 and 141 through 150 to any bond issued prior to the general applicability date under § 1.103-1(d)(1). The effect of the amendment to § 1.103-1(d)(3) is that the proposed definition of political subdivision will not apply for any purpose under sections 103 and 141 through 150 to bonds issued to refund bonds covered by the transition rule in § 1.103-1(d)(2), provided that the weighted average maturity is not extended.

Correction to Publication

Accordingly, the notice of proposed rulemaking and notice of public hearing published in the Federal Register (81 FR 8870) on February 23, 2016, is corrected as follows:

§ 1.103-1 [Corrected]

1. On page 8873, third column, the third through twelfth lines of paragraph (d)(2) are corrected to read “bonds. For all purposes of sections 103 and 141 through 150, the definition of political subdivision in paragraph (c) of this section does not apply with respect to bonds that are issued before the general applicability date under paragraph (d)(1) of this section.”

2. On page 8873, third column, the third through eighteenth lines of paragraph (d)(3) are corrected to read “bonds. For all purposes of sections 103 and 141 through 150, the definition of political subdivision in paragraph (c) of this section does not apply with respect to refunding bonds that are issued on or after the general applicability date under paragraph (d)(1) of this section to refund bonds with respect to which paragraph (c) of this section otherwise does not apply, provided that the weighted average maturity of the refunding bonds is no longer than the remaining weighted average maturity of the refunded bonds.”

Martin V. Franks,
Chief, Publications and Regulations Branch,
Legal Processing Division, Associate Chief Counsel (Procedure and Administration).

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Summaries

Section 170 — Charitable Deduction

H.R. 4706 WOULD PROVIDE EXCLUSION FOR SOME CHARITY PAYMENTS. H.R. 4706, the Interest for Others Act of 2016, introduced by House Ways and Means Committee member Erik Paulsen, R-Minn., would provide a gross income exclusion for some interest and money market fund dividend income payments to charity.


Miscellaneous

BURR BILL WOULD REQUIRE IRS TO PROVIDE REASON FOR AUDIT. The Biased IRS Audit Systems (BIAS) Prevention Act, introduced by Senate Finance Committee member Richard Burr, R-N.C., would require the IRS to provide an explanation to taxpayers of why they are being selected for an audit and prohibit the IRS from conducting audits solely for research purposes.


Congressional News Releases

Section 170 — Charitable Deduction

BOUSTANY CALLS FOR TAX RELIEF FOR DISASTER VICTIMS. H.R. 3110 would give victims of natural disasters “every opportunity to get back on their feet” by providing, among other things, a higher deduction for charitable giving for disaster relief and expensing of qualified disaster expenses, House Ways and Means Tax Policy Subcommittee Chair Charles W. Boustany Jr., R-La., said in a March 15 release.

Full Text Citations: Doc 2016-5508; 2016 TNT 51-42

Section 501(c)(3) — Charities

TAX-EXEMPT SCHOOLS SUPPRESSING FREE SPEECH, SAYS ROSKAM. Tax benefits given to colleges and universities through section 501(c)(3) status or separate endowments should not be invoked as a reason to “stifle political speech on campus, especially during election years,” Rep. Peter J. Roskam, R-III., chair of the House Ways and Means Oversight Subcommittee, said at a March 2 panel hearing.

Full Text Citations: Doc 2016-4432; 2016 TNT 42-29

OVERSIGHT PANEL ‘BLATANTLY’ IGNORING BIGGER ISSUES, LEWIS Says. The House Ways and Means Oversight Subcommittee’s March 2 hearing on free speech rights at tax-exempt schools is outside the subcommittee’s jurisdiction, and the subcommittee is ignoring more pressing issues like poor taxpayer service and stolen identity refund fraud, ranking minority member John Lewis, D-Ga., said at the hearing.

Full Text Citations: Doc 2016-4434; 2016 TNT 42-30

Congressional Tax Correspondence

Section 170 — Charitable Deduction

LAND DONATIONS FACE ‘ADVERSARIAL’ AUDITS FROM IRS, LAWMAKERS SAY. Taxpayers seeking to use the conservation easement tax incentive by making charitable donations of land have reported facing “antagonistic, aggressively adversarial, lengthy, and expensive” audits by the IRS, Sen. Christopher Murphy, D-Conn., and Sen. Richard Blumenthal, D-Conn., said in a February 22 letter to IRS Commissioner John Koskinen.

Full Text Citations: Doc 2016-3799; 2016 TNT 36-32

Section 501 — Tax-Exempt Organizations

HATCH, BRADY, ROSKAM QUESTION SMU ABOUT ENDOWMENTS. In a February 8 letter to Southern Methodist University President R. Gerald Turner, Senate Finance Committee Chair Orrin G. Hatch, R-Utah, House Ways and Means Committee Chair Kevin Brady, R-Texas, and Ways and Means Oversight Subcommittee Chair Peter J. Roskam, R-III., requested information on how universities use endowments for charity.

Full Text Citations: Doc 2016-5942; 2016 TNT 54-47
Section 501(c)(3) — Charities

GRASSLEY QUESTIONS WOUNDED WARRIOR PROJECT’S EXEMPT STATUS. Reports that the Wounded Warrior Project, a section 501(c)(3) organization, is improperly using donated funds on lavish expenses would be a “breach of faith with donors, taxpayers, and, more importantly, veterans” if they are true, Senate Finance Committee member Chuck Grassley, R-Iowa, said in a March 18 letter to the organization.

Full Text Citations: Doc 2016-6038; 2016 TNT 55-25

Section 530 — Education Accounts

BANK GROUP SUPPORTS EDUCATION INCENTIVE BILL. In a February 24 letter to Sen. Mark Kirk, R-Ill., Camden R. Fine, president and CEO of Independent Community Bankers of America, expressed support for S. 2471, the 401(Kids) Education Savings Account Modernization Act of 2016, praising the bill’s provisions to expand education saving incentives.

Full Text Citations: Doc 2016-4125; 2016 TNT 39-43

Testimony Other Than IRS and Treasury

Section 501(c)(3) — Charities

PRINCETON STUDENT URGES PROTECTION OF UNIVERSITY FREE SPEECH. Lawmakers “must reaffirm the importance of free speech as a core American value” and condemn efforts to restrict free speech at private universities, Joshua Zuckerman of the Princeton Open Campus Coalition said at a March 2 House Ways and Means Subcommittee hearing on free expression at tax-exempt universities.

Full Text Citations: Doc 2016-4463; 2016 TNT 42-36

EXEMPTION AFFECTS GEORGETOWN’S FREE SPEECH POLICY, STUDENT SAYS. Georgetown University’s policy on free expression on campus is too restrictive in part because of concern about losing tax-exempt status, said Georgetown University Law Center student Alexander Atkins at a March 2 House Ways and Means Oversight Subcommittee hearing, adding that universities should be reminded of obligations to protect free speech.

Full Text Citations: Doc 2016-4464; 2016 TNT 42-37

CLEARER IRS GUIDANCE NEEDED ON 501(c)(3) ACTIVITIES, GROUP SAYS. Tax-exempt schools are employing “overly restrictive policies out of an abundance of caution and fear for their tax-exempt status,” Catherine Sevcenko of the Foundation for Individual Rights in Education said March 2 before a House Ways and Means Subcommittee panel, recommending the IRS issue clear guidance for political activities on campus.

Full Text Citations: Doc 2016-4466; 2016 TNT 42-38

PROFESSOR EXPLAINS POLITICAL ACTIVITY LIMITS FOR EXEMPT SCHOOLS. While the political activities of tax-exempt schools’ senior officials might be viewed as the officials acting in their official capacity, students “are more likely to be acting in their private, personal capacity,” Frances R. Hill of the University of Miami School of Law said at a March 2 House Ways and Means Committee panel.

Full Text Citations: Doc 2016-4467; 2016 TNT 42-39

Washington Roundup

Section 170 — Charitable Deduction

CHARITY ORG PRAISES CLINTON PLAN TO OFFER DEDUCTION EXEMPTION. A proposal by Democratic presidential candidate Hillary Clinton to exempt the charitable deduction from a specific deduction limit shows that Clinton “recognizes the unique value” of the deduction and its role in encouraging donations, Andrew Watt, president and CEO of the Association of Fundraising Professionals, said in a March 4 statement.

Full Text Citations: Doc 2016-4715; 2016 TNT 44-70
Summaries

Section 170 — Charitable Deduction

PASTOR AND WIFE DENIED ADDITIONAL MEDICAL, CHARITABLE DEDUCTIONS. The Tax Court held that a pastor and his wife weren’t entitled to medical expense deductions beyond those allowed by the IRS and that they were not entitled to charitable contribution deductions beyond those the IRS allowed because they failed to substantiate their alleged cash contributions. Charles E. Brown v. Commissioner, No. 18360-14 (T.C. Memo. 2016-39 United States Tax Court). 03 Mar 2016

Full Text Citations: Doc 2016-4586; 2016 TNT 43-12

Section 501(c)(3) — Charities

IRS MUST COMPLY WITH DISCOVERY ORDERS IN EXEMPT ORG SUIT. The Sixth Circuit denied an IRS petition for a writ of mandamus and ordered the IRS to comply with district court discovery orders in a suit filed by Tea Party groups, holding that the names, addresses, and taxpayer identification numbers of applicants for tax-exempt status are not return information under section 6103(b)(2)(A). United States v. NorCal Tea Party Patriots et al., No. 15-3793 (United States Court of Appeals for the Sixth Circuit). 22 Mar 2016

Full Text Citations: Doc 2016-6128; 2016 TNT 56-10; reprinted on p. 310.

Washington Roundup

Section 501(c)(4) — Civic Leagues, etc.

JUDICIAL WATCH SEEKS INFO ON DOJ’S IRS INVESTIGATION. Judicial Watch announced in a March 2 release that it has sued to overturn a lower court ruling that the Justice Department does not need to disclose information on the number of hours that attorney Barbara Bosserman spent on her investigation of the IRS screening of tax-exemption applications.

Full Text Citations: Doc 2016-4523; 2016 TNT 42-35

Editor’s Note: Full text documents are reprinted exactly as they were received from the issuing agency.
IRS Must Comply With Discovery Orders in Exempt Org Suit

The Sixth Circuit denied an IRS petition for a writ of mandamus and ordered the IRS to comply with district court discovery orders in a suit filed by Tea Party groups, holding that the names, addresses, and taxpayer identification numbers of applicants for tax-exempt status are not return information under section 6103(b)(2)(A).

UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT


No. 15-3793

On Petition for a Writ of Mandamus to the United States District Court for the Southern District of Ohio.

Argued: March 16, 2016
Decided and Filed: March 22, 2016

Before: KEITH, McKEAGUE, and KETHLEDGE, Circuit Judges.


OPINION

KETHLEDGE, Circuit Judge. Among the most serious allegations a federal court can address are that an Executive agency has targeted citizens for mistreatment based on their political views. No citizen — Republican or Democrat, socialist or libertarian — should be targeted or even have to fear being targeted on those grounds. Yet those are the grounds on which the plaintiffs allege they were mistreated by the IRS here. The allegations are substantial: most are drawn from findings made by the Treasury Department’s own Inspector General for Tax Administration. Those findings include that the IRS used political criteria to round up applications for tax-exempt status filed by so-called tea-party groups; that the IRS often took four times as long to process tea-party applications as other applications; and that the IRS served tea-party applicants with crushing demands for what the Inspector General called “unnecessary information.”

Yet in this lawsuit the IRS has only compounded the conduct that gave rise to it. The plaintiffs seek damages on behalf of themselves and other groups whose applications the IRS treated in the manner described by the Inspector General. The lawsuit has progressed as slowly as the underlying applications themselves: at every turn the IRS has resisted the plaintiffs’ requests for information regarding the IRS’s treatment of the plaintiff class, eventually to the open frustration of the district court. At issue here are IRS “Be On the Lookout” lists of organizations allegedly targeted for unfavorable treatment because of their political beliefs. Those organizations in turn make up the plaintiff class. The district court ordered production of those lists, and did so again over an IRS motion to reconsider. Yet, almost a year later, the IRS still has not complied with the court’s orders. Instead the IRS now seeks from this court a writ of mandamus, an extraordinary remedy reserved to correct only the clearest abuses of power by a district court. We deny the petition.

I.

A.

Every year, thousands of non-profit groups — churches, schools, charities, and other actors in what Tocqueville called America’s “civil life” — apply for exemption from federal taxes under section 501(c) of the Internal Revenue Code. In 2014, the IRS considered 117,525 such applications. See Internal Revenue Service Data Book 2014 at 57. Of those, the IRS rejected 89, or about 0.07%. Id.

Most groups apply for 501(c)(3) status, which permits them to receive tax-deductible donations and to engage in limited, issue-based political advocacy. Others apply as 501(c)(4) social-welfare organizations. Tax-exempt 501(c)(4) groups may not collect tax-deductible donations, but they may engage in relatively unfettered political advocacy, including election advocacy. 501(c)(4) groups range from national organizations — including the American Civil Liberties Union, the National Rifle Association, and the Sierra Club — to local neighborhood associations.

Applicants for tax-exempt status submit standardized forms: Form 1023 for aspiring 501(c)(3) organizations, and Form 1024 for aspiring 501(c)(4) organizations. Form 1023 asks applicants to describe their purposes and activities; the compensation of their officers and employees; their fundraising methods; their revenues, expenses, assets, and liabilities; and their plans (if any) to undertake political advocacy. Form 1024 asks applicants about their activities; the names and titles of their officers; their criteria for membership; their publications; and their revenues, expenses, and balance sheets.
Both forms say at the top of page one that the applications, if successful, will be “open for public inspection.” That is by Congressional design. The Internal Revenue Code requires that the application of every exempt organization be available for inspection by the general public at the national office of the IRS, as well as at the major offices of the organization. See 26 U.S.C. § 6104(a)(1)(A), (d)(1)(A)(iii). Even if the IRS denies an organization’s application, the IRS must publish the application and the denial letter, though (unless a court orders otherwise) it must first remove any identifying information. See 26 U.S.C. § 6104(a), (b)(1)(A), (b)(2), (c)(1); see also Treas. Reg. § 301.6104(a)-1(f).

Once the IRS has approved an application, the exempt organization must file a yearly information return, using a Form 990. This form asks about the group’s governance; the salaries or benefits paid to its employees and members; the amount of contributions and grants it received that year; and the amount spent on furthering its mission. The form also asks for a detailed report of the group’s revenues, expenses, and balance sheet. Often, the group must attach a Schedule B, a list of the names and addresses of its major donors that year. Similar to Form 1023 and Form 1024, Form 990 is marked at the top of its first page, “Open to Public Inspection.” The IRS and the group itself must make the group’s return publicly available, with the proviso that the IRS must not — and each group need not — disclose the names or addresses of the group’s donors as revealed on Schedule B. See 26 U.S.C. §§ 6104(b), (d)(1)(A)(i), (d)(3)(A).

Congress thus created a regime in which all of the information demanded in a successful application for 501(c) tax-exempt status is presumptively open to the public. The same is true of the information revealed in an exempt organization’s annual return, save for the identities of individual donors. And the few unsuccessful applications are presumptively open to the public once any identifying information has been redacted. As for pending or dormant applications, the IRS treats the information contained in those applications as confidential “return information,” not to be revealed except under limited circumstances. See 26 U.S.C. § 6103(a); Treas. Reg. § 301.6104(a)-1(d), (g).

B.

In 2010, the IRS began to pay unusual attention to 501(c) applications from groups with certain political affiliations. As found by the Inspector General, the IRS “developed and used inappropriate criteria to identify applications from organizations with ‘Tea Party’ in their names.” IG Report at 5. The IRS soon “expanded the criteria to inappropriately include organizations with other specific names (Patriots and 9/12) or policy positions.” ld. As to the policy positions, the IRS gave heightened scrutiny to organizations concerned with “government spending, government debt or taxes,” “lobbying to ‘make America a better place to live,’” or “criticizing how the country is being run.” ld. at 6. The IRS collected these criteria on a spreadsheet that would become known as the “Be On the Lookout” criteria. See also Treas. Reg. § 501.6104(i)-1(d). The IRS flagged with the “Be On the Lookout” criteria were sent to a so-called “team of specialists,” where the applicants “experienced significant delays and requests for unnecessary information[].” IG Report at 7. As for the delays, “the IRS’s goal for processing all types of applications for tax-exempt status was 121 days in Fiscal Year 2012[,].” ld. at 1. “In comparison, the average time a potential political case [i.e., an application from one of the groups targeted with these criteria] was open as of December 17, 2012, was 574 calendar days[].” ld. at 15. Thus, as of that date, “many organizations had not received an approval or denial letter for more than two years after they submitted their applications. Some cases have been open during two election cycles (2010 and 2012)” — and, as of December 2012, some had been open “for more than 1,000 days.” ld. at 11, 14. These delays themselves brought adverse consequences for the applicant groups: the IG observed that, for “501(c)(3) organizations, this means that potential donors and grantors could be reluctant to provide donations or grants. In addition, some organizations withdrew their applications and others may not have begun conducting planned charitable or social welfare work.” ld. at 12.

The IRS’s application forms for tax-exempt status themselves request detailed information from every applicant group. For groups subject to the IRS’s inappropriate criteria, however, the IRS also demanded what the IG called “unnecessary information.” Among other things, the IRS demanded that many of these groups provide the following: “the names of donors”; “a list of all issues that are important to the organization[,]” and the organization’s “position regarding such issues”; “the roles and activities of the audience and participants” at the group’s events (typically over a 12-18 month period), and “the type of conversations and discussions members and participants had during the activity”; whether any of the group’s officers or directors “has run or will run for public office”; “the political affiliation of the officer, director, speakers, candidates supported, etc.”; “information regarding employment” of the group’s officers or directors; and “information regarding activities of another organization — not just the relationship of the other organization to the applicant.” ld. at 20. These demands, according to the IG, “created [a] burden on the organizations that were required to gather and forward information that was not needed by the IRS and led to delays in processing the applications.” ld. at 18. Moreover, “[f]or some organizations, this was the second letter received from the IRS requesting additional information, the first of which had been received more than a year before.[].” ld. This second round of letters also warned that the IRS would close the applicant’s case if the IRS did not receive all of the requested information within 21 days — “despite the fact that the IRS had done nothing with some of the applications for more than one year.” ld. at 7.

The experience of the lead plaintiff in this case, NorCal Tea Party Patriots, provides an example. NorCal applied for tax-exempt status in April 2010. In July 2010, the IRS sent NorCal a letter requesting additional information to process its application. NorCal promptly replied with 120 pages of responsive material. Eighteen months passed without further word from the IRS. Then, in a letter dated
groups’ applications were taxpayer ‘‘return information’’ that the names of IRS employees who worked on the of continuous resistance. For example, the IRS asserted the record before us here, the IRS’s response has been one of applications from similar groups that had been ing the names of IRS employees who reviewed the of basic information relevant to class certification, includ-

ing because of their political beliefs. U.S.C. §§ 6103(a), 7431 (creating a cause of action for inspection of confidential ‘‘return information.’’ Internal Revenue Code’s prohibition on the unauthorized in an application for tax-exempt status, violated the with other sensitive information not typically requested nal exchange of information about their donors, along with all newsletters, emails, or advertising materials that the group had sent to its members or to the general public. The IRS’s letter also reminded NorCal that, ‘‘[i]f we approve your application for exemption, we will be required by law to make the . . . information you submit in response to this letter available for public inspection.’’ The IRS directed NorCal to respond by February 17, 2012 — three weeks after the date of the letter — and told NorCal that, ‘‘[i]f we don’t hear from you by the response due date . . . we will assume you no longer want us to consider your application for exemption and will close your case. As a result, the Internal Revenue Service will treat you as a taxable entity.’’ NorCal eventually provided approximately 3,000 pages of responsive material.

The IRS’s own Taxpayer Advocate seconded many of the findings in the IG’s Report. But the response of IRS Management was muted. Although the IRS acknowled-
edged — in the classically passive formulation — certain ‘‘mistakes that were made in the process by which these applications were worked[,]’’ the IRS asserted that ‘‘centralization was warranted’’ in processing the requests, because ‘‘[c]entralization of like cases furthers quality and consistency.’’ IG Report at 44-45.

C.

One week after the release of the Inspector General’s report, the plaintiffs brought this lawsuit against the IRS and certain IRS officials. The plaintiffs asserted claims under the Privacy Act, 5 U.S.C. § 552a, and under the First and Fifth Amendments to the U.S. Constitution. The plaintiffs also claimed that the IRS’s collection and internal exchange of information about their donors, along with other sensitive information not typically requested in an application for tax-exempt status, violated the Internal Revenue Code’s prohibition on the unauthorized inspection of confidential ‘‘return information.’’ See 26 U.S.C. §§ 6103(a), 7431 (creating a cause of action for violations of § 6103). The plaintiffs also sought to certify a class of organizations allegedly targeted by the IRS because of their political beliefs.

To that end, the plaintiffs sought discovery in the form of basic information relevant to class certification, including the names of IRS employees who reviewed the groups’ applications for tax-exempt status and the number of applications from similar groups that had been granted, denied, withdrawn, or were still pending. On the record before us here, the IRS’s response has been one of continuous resistance. For example, the IRS asserted that the names of IRS employees who worked on the groups’ applications were taxpayer ‘‘return information’’ protected from disclosure by § 6103. The IRS eventually abandoned that position, but argued instead that § 6103 barred the Department of Justice’s attorneys from even reviewing the groups’ application files to find the names of the IRS employees who worked on them. That was true, the IRS asserted, even though § 6103(h)(2) — entitled ‘‘Department of Justice’’ — expressly allows the Department’s attorneys to review a taxpayer’s return information to the extent the taxpayer ‘‘is or may be a party to’’ a judicial proceeding. See 26 U.S.C. § 6103(h)(2)(A). The IRS further objected — this, in a case where the IRS forced the lead plaintiff to produce 3,000 pages of what the Inspector General called ‘‘unnecessary information’’ — that ‘‘it would be unduly burdensome’’ for the IRS to collect the names of the employees who worked on the groups’ applications. The district court eventually intervened and declared the IRS’s objections meritless. Yet the IRS objected to still other document requests on grounds of ‘‘the deliberative process privilege[,]’’ That privilege, the IRS acknowledged, can be waived in cases involving ‘‘government misconduct’’; but in the IRS’s reading, the IG’s report ‘‘does not include any allegation or finding of misconduct.’’ Eventually the district court’s patience wore thin. The court began a discovery conference in December 2014 by stating: ‘‘It looks like everything in this case seems to be turning into an argument on discovery. I think we’ve already had more discovery conferences in this case than I’ve had in any other case this whole year.’’ In the same conference the court admonished the IRS: ‘‘this is class discovery, but you’re not willing to give any discovery on the putative class . . . you’re just running around in circles and not answering the questions.’’ Those admonitions appeared to have little effect. In October 2015, the court stated as follows:

My impression is the government probably did something wrong in this case. Whether there’s likelihood or not is a legal question. However, I feel like the government is doing everything it possibly can to make this as complicated as it possibly can, to last as long as it possibly can, so that by the time there is a result, nobody is going to care except the plaintiffs. . . . I question whether or not the Department of Justice is doing justice.

The document requests specifically at issue here concern the plaintiffs’ requests for any lists of organizations that the IRS flagged for special attention using the ‘‘Be On the Lookout’’ criteria, as well as two spreadsheets that the IRS provided to the Inspector General in connection with his report. The plaintiffs specified that they wanted ‘‘the names of class members as shown on the IRS’s internal lists’’ so that plaintiffs could identify fellow members of the putative class. The IRS refused to produce the lists and instead moved for a protective order from the district court. In support, the IRS argued that any information contained in an application for tax-exempt status, including the applicant’s name, is confidential ‘‘return information’’ that the IRS is barred from disclosing to the district court. The district court, for its part, agreed that the plaintiffs’ requests encompassed ‘‘return information’’; but the court held that the IRS could disclose the documents nonetheless under an exception allowing disclosure where ‘‘the treatment of an item reflected on such
return is directly related to the resolution of an issue” in a judicial proceeding. 26 U.S.C. § 6103(h)(4)(B). The district court thus ordered the IRS to produce the documents. The IRS moved for reconsideration, and the court modified its order to permit the IRS to redact any employer identification numbers; but otherwise the court again ordered production of the documents.

The IRS then filed this petition for a writ of mandamus.

II.

A.

The writ of mandamus is a “drastic and extraordinary remedy reserved for really extraordinary causes.” Cheney v. U.S. Dist. Court, 542 U.S. 367, 380 (2004). Mandamus should issue only in “exceptional circumstances” involving a “judicial usurpation of power” or a “clear abuse of discretion.” Id. To obtain the writ here, the IRS must show that it lacks any other adequate means of obtaining relief, that its right to relief is “clear and indisputable,” and that issuance of the writ is “appropriate under the circumstances.” Id. at 380-81.

The IRS argues that the “names and other identifying information of” organizations that apply for tax-exempt status — along with the applications themselves — are confidential “return information” under 26 U.S.C. § 6103. IRS Petition at 2, 16. The IRS argues further that the district court lacked authority to order disclosure of those names under a statutory provision for disclosure in judicial proceedings where “the treatment of an item reflected on such return is directly related to the resolution of an issue in the proceeding[.]” 26 U.S.C. § 6103(h)(4)(B). The IRS contends that the district court’s discovery orders threaten to undermine statutory protections for taxpayer privacy, and that a writ of mandamus is therefore appropriate.

B.

In this country taxpayer privacy has a checkered history. The nation’s first federal income-tax statute did not keep taxpayer information confidential. To the contrary, when Congress passed an income tax to finance the Civil War, courthouses and newspapers published household tax information as a way of encouraging ordinary citizens to police their neighbors’ compliance with the new law. See Office of Tax Policy, Dep’t of the Treasury, Scope & Use of Taxpayer Confidentiality & Disclosure Provisions, Vol. I at 15 (2000). In the early twentieth century, Congress continued to classify tax returns as public information to open to general inspection, subject to regulations promulgated by the Treasury Department. Id. at 17-18. Eventually those regulations made individual and corporate tax returns generally available to federal agencies and committees of Congress, but unavailable to the general public. Id. at 20.

The dangers of that regime became clear when Congress investigated President Richard Nixon’s alleged abuses of power in connection with his 1972 reelection campaign. Congressional committees heard testimony that the White House had obtained from the IRS sensitive tax information on political opponents, and moreover had directed IRS personnel to audit the returns of particular taxpayers. The House Judiciary Committee thereupon approved an Article of Impeachment alleging that President Nixon had, among other things, “endeavored . . . to cause, in violation of the constitutional rights of citizens, income tax audits or other income tax investigations to be initiated or conducted in a discriminatory manner.”

In the wake of President Nixon’s resignation, Congress enacted the Tax Reform Act of 1976, which overhauled the rules governing disclosure of taxpayer information. No longer would the Executive have free rein over the handling of sensitive taxpayer records; instead, as the Treasury Department’s Office of Tax Policy acknowledged, “Congress undertook direct responsibility for determining the types and manner of permissible disclosures.” Office of Tax Policy, Taxpayer Confidentiality Provisions, Vol. I at 22.

At the core of this statutory regime is the general rule that “[r]eturns and return information shall be confidential[,]” 26 U.S.C. § 6103(a). “Returns” include any “tax or information return,” as well as “supporting schedules . . . which are supplemental to, or part of, the return so filed.” 26 U.S.C. § 6103(b)(1). Congress has carefully delineated the circumstances in which returns or return information can be disclosed to government officials or to the public. IRS officials may, for example, disclose a taxpayer’s own return or return information to that taxpayer. See 26 U.S.C. § 6103(c). In certain cases, federal officials must disclose returns and return information to state tax administrators and local law enforcement. See 26 U.S.C. § 6103(d). And the IRS must disclose returns and return information to Congressional committees upon written request. See 26 U.S.C. § 6103(f).

Here, the parties and the district court agree — as do we — that applications for tax-exempt status are not “returns.” See § 6103(b)(1). Rather, the parties say that the applications are “return information,” which includes, among other things, “a taxpayer’s identity” and “data . . . collected by the Secretary with respect to . . . the determination of the existence, or possible existence, of [tax] liability (or the amount thereof)[.]” 26 U.S.C. § 6103(b)(2)(A). Thus, in the parties’ view, the applicant names on the “Be On the Lookout” lists and spreadsheets are “return information.” As described above, the district court accepted that proposition, but held nonetheless — per the argument of plaintiffs alone — that the names on the lists and spreadsheets were subject to disclosure under § 6103(b)(4)(B). That subsection provides:

(4) Disclosure in judicial and administrative tax proceedings. — A return or return information may be disclosed in a Federal or State judicial or administrative proceeding pertaining to tax administration, but only —

(B) if the treatment of an item reflected on such return is directly related to the resolution of an issue in the proceeding[.]”

The IRS argues that the district court’s application of this subsection was mistaken because § 6103(b)(4)(B) authorizes disclosure only of information reflected on a
One views subsections (B) and (C) together: closure of "return or return information" alike; other circumstances described in those subsections warrant distinctions (A)-(D). In Congress's judgment, some of the circumstances described in those subsections warrant disclosure of "return or return information" may be disclosed as provided in subsections (A)-(D). But that argument is plainly wrong. The prefatory language states that "a return or return information may be disclosed" under ("but only" under) the circumstances described in subsections (A)-(D). In Congress's judgment, some of the circumstances described in those subsections warrant disclosure of "return or return information" alike; other circumstances, namely those described in the subsection at issue here, warrant disclosure only of information reflected on a "return." The point becomes clearer when one views subsections (B) and (C) together:

A return or return information may be disclosed in a Federal or State judicial or administrative proceeding, but only —

... (B) if the treatment of an item reflected on such return is directly related to the resolution of an issue in the proceeding; [or]

(C) if such return or return information directly relates to a transactional relationship between a person who is a party to the proceeding and the taxpayer which directly affects the resolution of an issue in the proceeding.[] 26 U.S.C. § 6103(h)(4) (emphasis added).

It was Congress's prerogative to authorize broader disclosure of taxpayer information under the circumstances described in subsection (C) than in the circumstances described in subsection (B). And the mere existence of subsection (C), not to mention (A) and (D), shows that the words "or return information," as used in the prefatory language, have plenty of meaning in § 6104(h)(4). Thus, reading subsection (B) to mean what it says — to authorize disclosure only of information reflected on a return — does not render meaningless the words "or return information" as used in the prefatory language. Instead that reading honors Congress's choice in crafting the provisions. See Dep't of Homeland Sec. v. MacLeain, 135 S. Ct. 913, 919 (2015) ("Congress generally acts intentionally when it uses particular language in one section of a statute but omits it in another").

We therefore hold that 26 U.S.C. § 6103(h)(4)(B) means what it says: only information that is "reflected on a return" may be disclosed under section 6103(h)(4)(B); return information that is not reflected on a return may not be. Accord In re United States, 669 F.3d 1333, 1339-40 (Fed. Cir. 2012). The district court was mistaken when it held otherwise.

2. But that does not mean the IRS is entitled to the extraordinary relief it seeks here. For § 6103(h)(4) provides neither the first word nor the last on the question whether the names of applicants for tax-exempt status are subject to disclosure as ordered by the district court. The first word is on the front of the IRS application forms themselves: "If exempt status is approved, this application" — including of course the applicant's name — "will be open for public inspection." The last word comes from two provisions that the IRS fails to mention in its petition: 26 U.S.C. §§ 6104 and 6103(b)(6).

a. As discussed above, the IRS contends in its petition that the "names and other identifying information of" applicants for tax-exempt status are generally barred from disclosure under § 6103. IRS Petition at 2, 16. But § 6104 mandates precisely the opposite for applicants whose applications are granted. Under § 6104, any successful application for 501(c) or 501(d) tax-exempt status, "together with any papers submitted in support of such application . . . shall be open to public inspection at the national office of the Internal Revenue Service." 26 U.S.C. § 6104(a)(1)(A). In that respect, among others, applications for tax-exempt status are very different from tax returns. As relevant here, under § 6104, the name of every successful applicant for tax-exempt status is indisputably public in character. The IRS itself says as much in the header of the application forms that every applicant for tax-exempt status must fill out. (See the preceding paragraph.) The IRS said as much when requesting "additional information" from NorCal, when it warned that, "[i]f we approve your application for exemption, we will be required by law to make the application and the information that you submit in response to this letter available for public inspection." The IRS said as much even in this litigation — during the IRS's retreat from the foothills of § 6103(h) — when it wrote to plaintiffs' counsel that "[s]ection 6104(a)(1)(A) permits the public inspection of any letter or document the IRS issued to an applicant whose application for 501(c) status is approved[.]" And the IRS's lawyer conceded in oral argument before this court that "the names of entities that are approved, I agree, are public." Yet the IRS failed to mention this elementary legal truth in the district court or in its petition for extraordinary relief from this court. We therefore hold the obvious: the names and identifying information of groups whose applications for tax-exempt status the IRS has already granted are public information under § 6104. And that means the IRS's petition is patently meritless as to the names and identifying information of groups whose applications the IRS has since granted — which is presumably most of the names and information at issue here, given the very high approval rate of tax-exemption applications generally.

b. That leaves the names of organizations whose applications remain pending, or who withdrew their applications, or whose applications the IRS rejected. Presumably none of the applications reflected on the "Be On the Lookout" lists are still pending, since those applications...
were filed over four years ago. But there are likely some groups who chose to withdraw their applications rather than contend with the IRS’s long delays and requests for “additional information.” For the most part the information submitted in those applications remains confidential “return information.” See Treas. Reg. § 301.6104(a)-(1)(d), (g). And presumably the IRS outright denied the applications of some of the groups it allegedly targeted.

Yet the prospect of any pending, withdrawn, or denied applications only leads us back to a more fundamental question: whether the names and identifying information of applicants for tax-exempt status are “return information” in the first place. As noted above, “return information” as defined by §6103(b)(2)(A) includes “a taxpayer’s identity[.]” That term sounds like it might include an applicant’s name. But here again the IRS has failed to mention a relevant statutory provision, this time § 6103(b)(6). That provision states in full: “The term ‘taxpayer identity’ means the name of a person with respect to whom a return is filed, his mailing address, his taxpayer identification number (as described in section 6109), or a combination thereof.” (Emphasis added.) The word “return” has a meaning just as concrete in § 6103(b)(6) as it did in § 6103(h)(4); and that meaning does not include an application for tax-exempt status. See § 6103(b)(1). Applicants qua applicants file applications, not “returns”; and thus the name of an applicant for tax-exempt status does not fall within a “taxpayer’s identity” as that term is defined in §6103(b)(6) and used in §6103(b)(2)(A). On this point Congress drew a clear line, whose contours follow the meaning of “return.” We follow that line here just as we did in interpreting §6103(h)(4).

The IRS responded at oral argument — as it always seems to respond when seeking to withhold documents in cases involving §6103 — that the names of applicants for tax-exempt status are “other data, received by, recorded by, furnished to, or collected by the Secretary . . . with respect to the determination of the existence, or possible existence, of liability” for a tax. See §6103(b)(2)(A). But that argument would prove too much. If “data collected” by the Secretary includes the name of an applicant for tax-exempt status, so too it includes the name of a taxpayer who files a return. And in that event Congress was wasting its time when it included “taxpayer identity” as a type of return information under §6103(b)(2)(A), since a taxpayer’s name would already be “data collected” (and thus return information) under the IRS’s unbounded conception of that term. And Congress was wasting its time yet again when it carefully defined “taxpayer identity” in §6103(b)(6) to include names on returns but not applications — because again, in the IRS’s view, both types of names are data collected (and thus return information). All of which is to say that, as a matter of elementary statutory interpretation, the IRS’s assertion that applicant names are return information is meritless.

Section 6104 likewise reveals that the names of applicants for tax-exempt status are not “return information.” The point is highly technical but worth making here. Section 6104(c) provides a mechanism by which the IRS may tip off state authorities regarding the IRS’s intention to deny tax-exempt status to an organization that has applied for it. See 26 U.S.C. § 6104(c)(2). That subsection specifies in one subparagraph that the IRS may disclose to state authorities “the names, addresses, and taxpayer identification numbers of organizations which have applied for recognition as organizations described in section 501(c)(3).” 26 U.S.C. § 6104(c)(2)(A)(iii) (emphasis added). The next subparagraph authorizes the IRS to make “additional disclosures,” namely, “[r]eturns and return information of organizations with respect to which information is disclosed under subparagraph (A) may be made available for inspection by or disclosed to an appropriate State officer.” 26 U.S.C. § 6104(c)(2)(B) (emphasis added). But Congress would have had no need separately to authorize disclosure of the “names, addresses, and taxpayer identification numbers” in §6104(c)(2)(A)(iii) if that information was already “return information” subject to disclosure under §6104(c)(2)(B). The rules of statutory interpretation cut both ways, and the rules that cut in favor of the IRS’s reading of §6103(h)(4)(B) here cut against the IRS’s reading of “return information” to include applicant names and identifying information.

Still more support for our interpretation comes from the D.C. Circuit’s opinion in Ryan v. Bureau of Alcohol, Tobacco & Firearms, 715 F.2d 644 (D.C. Cir. 1983) (Scalia, J.). There the court considered a situation analogous to the one presented here: whether a member of the public could access a list of the names of manufacturers that had submitted Forms 4328, which provided notice of intent to engage in the manufacture of domestic liquor bottles. The ATF resisted disclosure on the ground that the names were return information under §6103 because they had been provided “for ascertaining tax liability.” Id. at 645. The district court agreed. But then-Judge Scalia, writing for himself and then-Judge Ruth Bader Ginsburg, declined to affirm on those grounds. Instead he concluded that Form 4328 was an “information return” within the meaning of §6103(b)(1), and that — because the manufacturers had filed a “return” — the manufacturers’ names fell within the term “taxpayer identity” as defined by §6103(b)(6) and used in §6103(b)(2)(A). 715 F.2d at 647. Here, unlike in Ryan, the applications at issue — the Forms 1023 and 1024 submitted to the IRS — are undisputedly not returns.

We recognize that, in another case, the D.C. Circuit held that the names of applicants for tax-exempt status are “return information.” See Landmark Legal Foundation v. IRS, 267 F.3d 1132, 1135 (D.C. Cir. 2001). But that holding is unpersuasive for a simple reason. The Landmark court stated that the names of applicants for tax-exempt status are “return information” because §6103(b)(2)(A) “specifically covers ‘a taxpayer’s identity,’” Id. (quoting §6103(b)(2)(A)) (emphasis in original). But the court never referenced Congress’s express definition of that term in §6103(b)(6) — the IRS apparently failed to mention it there — and thus the court seemed unaware throughout that “taxpayer’s identity” includes only names on a return, not on an application.

For all of these reasons, we hold that the names, addresses, and taxpayer-identification numbers of applicants for tax-exempt status are not “return information” under §6103(b)(2)(A). And we otherwise emphasize that the phrase “data, received by, recorded by, furnished to, or collected by the Secretary[,]” as used in §
6103(b)(2)(A), does not entitle the IRS to keep secret (in the name of “taxpayer privacy,” no less) every internal IRS document that reveals IRS mistreatment of a taxpayer or applicant organization — in this case or future ones. Section 6103 was enacted to protect taxpayers from the IRS, not the IRS from taxpayers.

* * *

In closing, we echo the district court’s observations about this case. The lawyers in the Department of Justice have a long and storied tradition of defending the nation’s interests and enforcing its laws — all of them, not just selective ones — in a manner worthy of the Department’s name. The conduct of the IRS’s attorneys in the district court falls outside that tradition. We expect that the IRS will do better going forward. And we order that the IRS comply with the district court’s discovery orders of April 1 and June 16, 2015 — without redactions, and without further delay.

The petition is denied.

* * *

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Editor's Note: New summaries and those amended since last month's edition of The Exempt Organization Tax Review are preceded by a ✶.

Section 501(c)(3) — Charities

Educational Assistance Foundation for the Descendants of Hungarian Immigrants in the Performing Arts Inc. v. United States, No. 1:11-cv-01573. On July 1, 2015, the U.S. District Court for the District of Columbia held that the IRS didn’t abuse its discretion when it retroactively revoked the tax-exempt status of a foundation established to provide educational assistance to the descendants of Hungarian immigrants in the performing arts because the foundation was organized and operated to benefit one family.

On July 30, 2015, the foundation appealed the decision to the D.C. Circuit Court of Appeals, and the case was docketed at No. 15-5213.

On September 25, 2015, the court granted the government’s request to suspend the briefing schedule and hold the case in abeyance pending settlement negotiations in related litigation.

According to status reports filed in January 2016 by the government and the foundation, the settlement proceedings are still ongoing.

True the Vote Inc. v. IRS, No. 1:13-cv-00734. On October 23, 2014, the U.S. District Court for the District of Columbia dismissed claims filed by the nonprofit corporation True the Vote Inc. seeking damages for constitutional rights violations and unauthorized disclosure. The group also sought declaratory and injunctive relief against the IRS and IRS officials. The group alleged that the IRS subjected its exempt status application to additional scrutiny because of its mission of promoting election integrity and its perceived Tea Party association.

On December 19, 2014, True the Vote filed an appeal to the D.C. Circuit, and the case was docketed at No. 14-5316.

The circuit court denied True the Vote’s motion for summary reversal of the district court’s dismissal on September 23, 2015.

On December 7, 2015, the group filed its appellant brief.

On February 5, 2016, the government filed its appellant brief.

✶Loren E. Parks v. Commissioner, Nos. 7043-07, 7093-07. On November 17, 2015, the U.S. Tax Court held that the tax-exempt Parks Foundation made taxable expenditures for the production and radio broadcast of messages regarding measures appearing on the Oregon state ballot. The Tax Court held that the messages were an attempt to influence legislation, that they were not for an exempt purpose, and that the foundation was liable for excise taxes under section 4945. The court also held Loren E. Parks, the foundation’s manager who approved the expenditures, liable for section 4945 excise taxes.

On March 7, 2016, Parks and the Parks Foundation filed a motion with the Tax Court to withhold entry of the decision.

Section 501(c)(4) — Civic Leagues, etc.

✶NorCal Tea Party Patriots v. Internal Revenue Service, No. 1:13-CV-341. Plaintiffs allege the IRS subjected them to delays and intrusive scrutiny after they applied for tax-exempt status because of their political beliefs. They filed complaints alleging violation of the Privacy Act, 5 U.S.C. section 552; violations of the First and Fifth Amendments; and violation of the tax return confidentiality rules of section 6103. The plaintiffs also sought to certify a class made up of additional organizations alleging unfair treatment by the IRS.

On January 12 the U.S. District Court for the Southern District of Ohio certified the class action.

On March 22, the Sixth Circuit denied the IRS’s petition for a writ of mandamus and ordered the IRS to comply with district court discovery orders; see p. 310 for the opinion.
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--Chris Bergin
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Only in the pages of Tax Analysts
Arkansas

Finance Department: Church Baseball League’s Purchases Not Exempt From Sales Tax

The Arkansas Department of Finance and Administration advised a business that sells concession items to a church baseball league that it must collect sales tax on its items until the baseball league provides a copy of an exempt resale certificate or an opinion letter from the department verifying that it is exempt from taxation.

Full Text Citations: Doc 2016-3268; 2016 STT 31-11

Finance Department: Film Festival Organization’s Online Sales Are Subject to Tax

The Arkansas Department of Finance and Administration informed an Arkansas-based organization that produces documentary film festivals that despite being recognized as a nonprofit, sales through its online website are not exempt from tax because the organization’s purpose is not benevolent, philanthropic, or eleemosynary in nature.

Full Text Citations: Doc 2016-5506; 2016 STT 51-10

Iowa

DOR Says Foundation Does Not Qualify for Tax Exemption

The Iowa Department of Revenue informed a section 501(c)(3) charitable public foundation that, with the information it provided, the DOR could not determine if it was a designated tax-exempt entity for construction contracts, because it could not be considered an instrumentality of the city of Ankeny.

Full Text Citations: Doc 2016-4136; 2016 STT 39-17

DOR Says Local Chamber of Commerce Does Not Qualify for Tax Exemption

The Iowa Department of Revenue informed the Ames Chamber of Commerce that based on the information it provided, the Chamber is not an instrumentality of the city of Ames and is not eligible for a sales and use tax refund for construction contracts related to the construction of a local airport.

Full Text Citations: Doc 2016-4228; 2016 STT 40-14

DOR Provides Sales Tax Guidance to Historical Society

The Iowa Department of Revenue provided a non-profit historical society with guidance to help determine whether the organization’s museum qualified for a sales tax exemption certificate and explained which purchases qualified for the exemption.

Full Text Citations: Doc 2016-4232; 2016 STT 40-15

Georgia

Policy Group Analyzes Proposed Bill Offering Tax Credit for Donations to Rural Hospitals

The Georgia Budget and Policy Institute has released an analysis of HB 919, proposed legislation that would create a $250 million tax credit program for donations to rural hospitals, and argued that rural communities would be better served if lawmakers expanded access to Medicaid or increased Medicaid payments to doctors and healthcare centers.

Full Text Citations: Doc 2016-3992; 2016 STT 38-16
Kentucky

Court of Appeals Holds Constitution’s Property Tax Exemption Exempts Charitable Institution From Use Tax

The Kentucky Court of Appeals held that the Kentucky Constitution does exempt institutions of purely public charity from a tax on the storage, use, or consumption of property, reasoning that although the state’s use tax is an excise tax, it functions sufficiently like a property tax for charities to be exempt under a property tax exemption statute.


Michigan

Court of Appeals Says Nonprofit Can Challenge Exemption Denial in Tax Tribunal

The Michigan Court of Appeals held that a nonprofit elderly housing development could challenge a local assessor’s property tax exemption denial at the tax tribunal because a failure to approve or deny an application in the same year it’s made constitutes a de facto denial, but the tribunal lacked jurisdiction to consider criminal charges.

Full Text Citations: Doc 2016-4481; 2016 STT 42-17

Missouri

DOR Says Nonprofit Theater’s Alcohol, Snack Charges Are Tax Exempt

The Missouri Department of Revenue informed a nonprofit organization that offers live theatrical presentations that its charges for alcoholic beverages and light snacks are exempt from sales tax because it is recognized as a tax-exempt civic organization.

Full Text Citations: Doc 2016-5380; 2016 STT 50-15

DOR: Charity’s Online Sales Are Tax Exempt

The Missouri Department of Revenue explained that a tax-exempt charitable organization was not required to collect or remit sales tax on its online website sales because the items sold, and the sale proceeds, were deemed part of its charitable functions and activities.

Full Text Citations: Doc 2016-5390; 2016 STT 50-16

New Jersey

State Provides $25 Million in Tax Credits to Rutgers University

New Jersey S 2880, signed into law as Chapter 242, provides up to $25 million in tax credits under the economic redevelopment and growth grant program for infrastructure projects at Rutgers University.

Full Text Citations: Doc 2016-3487; 2016 STT 33-19

State Requires Urban Renewal Entities to File Financial Agreement for Long-Term Tax Exemption

New Jersey S 3019, signed into law as Chapter 247, requires an urban renewal entity developing or redeveloping a relocation housing project or low- and moderate-income housing project to file a financial agreement for long-term tax exemption on the land with the municipal clerk, and to submit quarterly payments in lieu of tax.

Full Text Citations: Doc 2016-3622; 2016 STT 35-19

Ohio

State Supreme Court Disallows Exemption for Property Leased by Nonprofit

The Supreme Court of Ohio held that a nonprofit was not entitled to a property tax exemption, even though the statute allowed the nonprofit to file an application for the exemption, because the property owner did not purport to have any charitable purpose.

Full Text Citations: Doc 2016-3348; 2016 STT 31-20

State Supreme Court Remands Case for Charitable-Use Exemption Determination

The Ohio Supreme Court held that the Board of Tax Appeals’ finding that a dialysis services center qualified for a charitable institution was reasonable, but held it was premature to grant the taxpayer a full property-tax exemption without a full analysis of the claim and remanded the case for further proceedings.

Full Text Citations: Doc 2016-3312; 2016 STT 31-21
State Supreme Court Rejects Bid to Expand Scope of Charitable Property Tax Exemption

by Brian Bardwell — brian.bardwell@taxanalysts.org

The Ohio Supreme Court on February 16 rejected a nonprofit’s bid to expand the definition of ownership for purposes of the state’s property tax exemption for charitable organizations.

The case centers on a 30,000-square-foot space owned by a commercial landlord and leased for 30 years to ShadoArt Productions Inc., a nonprofit arts organization that renovated to install a theater, kitchen, bistro, and office space.

ShadoArt, which the lease held responsible for property taxes, applied for the state’s charitable use exemption under R.C. section 5715.27, which says that “a lessee for an initial term of not less than thirty years of any property may file an application with the tax commissioner, on forms prescribed by the commissioner, requesting that such property be exempted from taxation.”

But the tax commissioner denied the application, pointing to R.C. sections 5709.12 and 5709.121, which allow charitable exemptions only for property “belonging to” a charitable or educational institution that uses it exclusively for public purposes.

ShadoArt appealed to the Board of Tax Appeals, which said that the first provision gave ShadoArt the authority only to apply for an exemption, not to receive one.

On appeal to the Ohio Supreme Court, ShadoArt contended that when the General Assembly expanded section 5715.27 to make long-term lessees eligible to seek exemptions, it must have also intended to simultaneously expand the scope of section 5709.12 and give them the right to actually receive the exemption.

The court rejected that position, saying that the amendment to section 5715.27 was meant only to address its 2004 decision in Performing Arts School of Metropolitan Toledo Inc. v. Wilkins, in which the court denied a school’s exemption application because it was the leaseholder of the property in question, rather than a titleholder.

While ShadoArt argued that reading the statutes together to permit an application but not an exemption “renders them meaningless,” the court pointed to a variety of other circumstances in which the amendment would allow certain leaseholders to both apply for and receive an exemption, including situations in which a charitable institution leases property from another charitable institution.

“Thus, in some situations, there is good reason to allow a lessee to file an application for exemption under R.C. 5709.12 and 5709.121,” the court said. “In short, contrary to ShadoArt’s claims, the General Assembly did not expressly or implicitly modify the charitable-use exemption when it authorized additional filers.”

The court said that accepting ShadoArt’s invitation would cause inconsistencies with other provisions and undermine its principle of narrowly construing exemption statutes.

That left the exemption’s availability contingent on the charitable status of ShadoArt’s landlord, which the parties had stipulated was a for-profit company that leases the property to generate income and had no charitable purpose.

Because the property was not owned by a charitable institution, the court affirmed the Board of Tax Appeals’ judgment.

South Dakota

State Exempts Transfers of Motor Vehicles to Nonprofits From Excise Tax

South Dakota HB 1113 as signed into law exempts transfers of motor vehicles to nonprofit organizations that are exempt under section 501(c)(3) and either donate the vehicle to a needy family or individual or sell the vehicle within 45 days of the transfer.

Full Text Citations: Doc 2016-3982; 2016 STT 38-38

State Exempts Fire Protection Nonprofits From Sales and Use Tax

South Dakota HB 1204 as signed into law provides a sales and use tax exemption for nonprofit corporations created for the purpose of fire protection and controlled by a political subdivision.

Full Text Citations: Doc 2016-5501; 2016 STT 51-18

Texas

AG Provides Guidance on Exemption for Texas A&M Property

The Texas attorney general said that property leased to students or employees of higher education institutions is tax exempt, but warned that if such property is leased to provide private housing to residents other than students and employees, it may lose its exemption in whole or in part.
Utah

Tax Commission Orders Audit Adjustment for Couple’s Utah Educational Savings Plan Credit

The Utah State Tax Commission found that a couple, who contributed to an educational savings account owned by their grantor trust, was entitled to a Utah Educational Savings Plan credit equal to 5 percent of their maximum qualified contribution for tax year 2010 and ordered an audit adjustment.

Full Text Citations: Doc 2016-3674; 2016 STT 35-27

Virginia

State Creates Tax Credit for Farmers Who Donate Crops to Food Banks

Virginia SB 580, signed into law as Chapter 304, creates an individual and corporate income tax credit for farmers who donate food crops to a nonprofit food bank.

Full Text Citations: Doc 2016-5170; 2016 STT 49-32

Washington

DOR Adopts Expedited Amendments to B&O Tax Rule for Educational Institutions

The Washington Department of Revenue has adopted expedited amendments to a rule on the business and occupation tax and retail sales tax reporting responsibilities of educational institutions and child care organizations to incorporate recent legislative changes to the taxation of amusement services and services that are provided electronically.

Full Text Citations: Doc 2016-5360; 2016 STT 50-28

Wyoming

State Extends Sales Tax Exemption for Meals Provided to Senior Citizens

Wyoming HB 67, signed into law as Chapter 92, revises the sales tax exemption for meals provided by senior centers to include meals delivered to the homebound and meals provided to senior citizens or guests of seniors.

Full Text Citations: Doc 2016-5274; 2016 STT 50-33
European Union

CJEU to Consider U.K. VAT Treatment of Education-Related Supplies

The Court of Justice of the European Union has published the reference for a U.K. case (C-699/15) on whether catering provided by a college’s restaurant and performances by its dramatic arts department were VAT-exempt supplies of education and/or vocational training.

Full Text Citations: Doc 2016-4385; 2016 WTD 41-14

United Kingdom

U.K. Consults on Options to Simplify Gift Aid Donor Benefits Rules

HM Treasury has launched a consultation on specific proposals for simplifying and improving the existing gift aid donor benefit rules; interested parties should submit comments by May 12.

Full Text Citations: Doc 2016-3529; 2016 WTD 33-21
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Alan Breus, “Gifting an Archive to a University,” Tr. & Est., Oct. 2015, at 50.

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