Analysis

IRS revokes US tax-exempt status of prominent UK charities

Speed read

The IRS has revoked the US tax exempt status of 195 prominent UK charities by posting their names on a website; some of these charities may not be aware of this. Revocation means that the tax incentives for US citizens (including those living here) and private foundations to make gifts or grants to these UK charities are materially reduced, and the reduction in US withholding tax for dividends and certain capital gains enjoyed by these UK charities on their US investments is immediately withdrawn. UK charities interested in the US should take a moment to check whether they are included on the IRS's revocation list. If they find that they are so included, they should take prompt action because the longer that their US tax status remains unresolved, the more costly and complicated remedial action will be.

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UK charities reasonably expect that their dealings with the US Internal Revenue Service (IRS) will be minimal – even if they have taken the step of substantiating their exemption from US taxation on the ground of being equivalent to analogous US institutions. Many UK charities have taken this step, desiring to attract US support from US individuals, donor-advised funds and private foundations, or to reduce withholding taxes on US investment income.

This expectation will be dashed when they discover in a backwater of the IRS website a list of 195 UK charities whose US tax exemption has been 'automatically revoked', ten of which have been 'reinstated' (see bit.ly/2v09uCT; click on 'Exempt organisations select check tool', then 'were automatically revoked'; then select 'United Kingdom' on the 'Country' drop-down list). Among the remaining 185 are: three prominent cancer relief charities; 23 colleges of the universities of Oxford, Cambridge and London; one university; two ancient schools; a prominent opera and orchestra; and several well-known charitable endowments – some or all of which may have achieved a reinstatement that has not yet been posted by the IRS. While some of these charities suffered revocation effective May 2010, it is likely that at least a few will not yet be aware of the IRS's action because the IRS was not obliged to communicate with them by letter.

The consequences of revocation to these listed UK charities are as follows:

1. US citizens, including those living here, cannot make lifetime or testamentary direct gifts that reduce their exposure to US estate and gift tax.
2. US citizens, wishing to obtain the US equivalent of gift aid by making lifetime gifts via intermediary US charities, will find those charities reluctant because they must verify that the UK donee uses the funds for charitable purposes.
3. US private foundations (e.g. the Ford Foundation) cannot make grants without exercising 'expenditure responsibility' and ensuring that the money is kept by the donee in a separate fund.
4. UK charities will not be entitled to reduced or zero rates of US withholding tax on dividends paid by US companies, and will suffer the US non-resident capital gains tax on all dispositions of US real property interests.

This article is intended for those UK charities (i.e. those recognised by HMRC, wherever formed in Britain) which have meaningful US investments or support from US persons. It explains the background of UK charities substantiating their US tax-exempt status, and outlines the reasons for and consequences of 'automatic revocation'. It goes on to describe the procedure for reinstatement, and its costs and benefits.

If nothing else, every UK charity with interests in the US should find out from the IRS website whether its US tax exemption has been revoked, if it has not already done so.

First, however, a few words on the heavy regulation of the US charitable sector by the IRS.

Background to the US regulation of charities

There being no US equivalent to the Charity Commission, the IRS is responsible for registering and recognising US charities. Upon review of a lengthy application (Form 1023 with 26 pages), the IRS will recognise those US entities which fulfil the charitable goals set forth in Internal Revenue Code (IRC) section 501(c)(3), whether religious, scientific or educational, etc., by issuing a 'determination letter'. There is substantial, but not complete, overlap between the eight goals of IRC section 501(c)(3) and the English law concept of charitable purpose, which allows many UK charities to demonstrate their 'equivalence' to US charities (meaning those described in IRC section 501(c)(3)).

US charities subdivide into two categories: those with broad public support or which pursue the traditional goals of operating a hospital, school or church ('public charities'); and those where support comes from a family or company and which usually operate by making grants to other charities ('private foundations') (IRC section 509(a)). Public charities must not engage in legislative influence or political campaigning, and their earnings must not result in the benefit of individuals. Private foundations are subject to detailed rules in the IRC against self-dealing, overly concentrated business holdings and excess accumulations, to ensure that they benefit the community rather than their founders.

In return for the tax benefits of exemption from income tax and tax incentives for their donors, US charities must explain in detail their finances, compensation arrangements, and operational achievements each year on forms that are made public (with donor information for public charities redacted). Public charities must complete the 12 pages and nine schedules of Form 990 each year (small public charities may complete Form 990-EZ); while private foundations are required to file Form 990-PF, which requires less information. Sunlight is a good disinfectant and detailed information allows potential donors to make better decisions. The attorney generals of the states supervise charities in areas such as aggressive solicitations; but most US charities are concerned more by the risk of 'intermediate sanctions' in the form of penalty taxes on the organisation and its management, and the final sanction of IRS revocation of their tax status and benefits.

Can UK charities qualify for US tax-exempt status, and why would they do so?

The IRS will recognise any charity in the world if it satisfies the functional equivalent of being 'described in' IRC section 501(c)(3), not insisting that it be formed under US law. Further, the IRS applies its customary criteria to non-US charities to distinguish between 'public charities' and 'private foundations'.

UK charities consider substantiating their US tax-exempt status because it facilitates attracting support from the US and leads to lower rates of US withholding tax on certain types of US-source income. US donors and private foundations can make tax-advantaged gifts to non-US charities that substantiate their 'equivalence' to US public charities without insisting on an accounting; and the rates of US withholding tax on dividends and capital gains from selling US real property (provided that leverage is not used) are reduced from the otherwise applicable rates under US domestic legislation or the US/UK Income Tax Treaty.

For example, a gift by a US private foundation to a UK college which has not substantiated its equivalence to a US public charity will need to be held in a separate account and its use carefully documented and justified to enable the grantor to demonstrate 'expenditure responsibility'; whereas if the UK college substantiates its equivalence, the US private foundation's responsibilities end at funding (see Treas. Reg. 53.4942(a)–3(a)(6), 53.4945-5(a)(5)). Regarding US investment, dividend income earned by a UK charity which has not substantiated its equivalence to a US charity suffers 15% US withholding tax, but upon substantiation only 4% (if a private foundation) or zero (if a public charity) (see Treas. Reg. 1.1441-9(a); IRC section 4948(a)). (Some UK charities are unaware of this reduced rate, perhaps because some pooling vehicles for UK charities are content to suffer 15% withholding tax on US dividends.)

Because of a quirk in the US legislation, US individuals wishing to donate directly to a UK charity that has substantiated its US tax-exemption are denied the US equivalent of Gift Aid (IRC section 170(c)(2)(A)). US public charities are not so constrained, and this has led to the practice of US individuals giving first to US charities in the expectation that they will on-gift to the ultimate intended recipient abroad (see Rev. Rul. 63-252, 1963-2 C.B. 101 (situation 4)). Indeed, some non-US charities have formed sister US public charities ('American Friends of' organisations) to attract US donations; the ones formed by Oxford and Cambridge to channel university and collegiate gifts are extremely successful, and there are 322 'American Friends of' charities formed in the state of New York alone.

How does a UK charity establish its US tax exemption?

Critically, only some non-US charities need to apply to the IRS for recognition, unlike their US equivalents; the balance may obtain written advice from US tax professionals on their US tax-exempt status, which they disclose to US donors and withholding agents. The IRS requires only those non-US charities which have material contacts with the US to apply for recognition on Form 1023, expressed as the proportion of support that they have received from US, versus non-US, sources during their existence (Treas. Reg. 53.4948-1(b)). Thus, if at least 85% of a UK charity's receipts from donations, grants, trading income and membership fees (but not investment income) has come from outside the US, it does not need to approach the IRS for recognition but rather may rely on written advice.

Also, exposure to filing the annual public information return with the IRS does not depend on whether the non-US charity has sought a determination letter; non-US charities which rely on written advice are not somehow penalised. Thus, any entity in the world that is 'described in' IRC s 501(c)(3) currently must file an annual information return with the IRS if it normally receives more than $50,000 in annual gross receipts from sources within the US, irrespective of how (or whether) it substantiates its US tax exemption (Rev. Proc. 2011-15, section 3.02, 2011-3 I.R.B. 322). (According to the IRS, every non-US public charity with fewer gross receipts must file a brief annual notice on Form 990-N, and every entity in the world that falls within the definition of a private foundation must file Form 990-PF, an overreaching rule whose absurdity has been noted.)

> Every UK charity interested in the US should check whether it is included on the list of revoked charities on the IRS website

Accordingly, one would expect that only those few UK charities which derive more than 15% of their support from US sources would bother to apply to the IRS for a determination letter. This is not the case, however, as many prominent UK charities have done so, perhaps because the IRS rules on their providing written advice to substantiate their status to US donors and withholding agents became clear only in the 1990s. Having obtained a determination letter, however, not all of these UK charities complied with their annual information return obligations (if their US-source gross receipts reached the filing threshold). Some lacked awareness; others acted on the principle that the transparency goals of the US regime were vastly outweighed by the costs of compliance (US donors could always consult the Charity Commission website).

Many US charities also were not filing annual information returns, either because their gross receipts fell below the threshold or out of non-compliance. It was Congress's reaction to this widespread non-filing which led to the mass automatic revocation of UK (and US) charities' status.

Impact of 2006 US legislation on UK charities

In 2006, Congress's attention was drawn to the large number of US 'tax-exempt organisations' (including charities and other non-profit entities, such as social welfare organisations), which had been recognised by the IRS or otherwise substantiated themselves but had then failed to provide annual information returns (sometimes justifiably because their annual gross receipts fell below the then-applicable threshold of $25,000). Congress legislated to require every US charity to file a basic notice (Form 990-N) each year, or one of the more elaborate Forms 990 if applicable, starting with the 2007 year (IRC section 6033(i)). Also, the IRS was required to revoke automatically the status of any US tax-exempt organisation which failed to do so for three consecutive years (IRC section 6033(j)). Upon revocation, in all cases the entity would need to seek an IRS determination letter in reinstatement, with retroactive effect upon proving that it had 'reasonable cause' for failing to file.

This legislation had an enormous impact starting in 2010 (when the due date fell for the return of the third consecutive year starting in 2007); at the last count, 689,577 US tax-exempt organisations have had their status revoked.

Despite efforts at streamlining, the IRS's procedures for granting determination letters collapsed under the weight of reinstatement applications. US donors seeking the US equivalent of Gift Aid were put to consulting the IRS website to see whether their favourite charities continued to qualify to receive tax-advantaged gifts, while entities on the revoked list attempted to calculate their US income tax liability as *taxable* entities, pending the IRS's consideration of their requests for retroactive reinstatement.

The IRS acted against non-US charities also, although it did not publicise the revoked list on its website and was not obliged to notify non-US entities by letter. Many UK charities were added to the list in 2011, suffering revocation effective on the earliest date (May 2010). The IRS took action against those UK charities of which it was aware; and it was aware only of those which had obtained a determination letter. So the good deed of having come forward to the IRS was punished, while those UK charities which had relied on the written advice of US tax professionals, as permitted by the US tax regulations, escaped revocation.

The consequences of revocation are that tax-advantaged gifts by US donors cannot be made without difficulty; and reduced rates of US withholding tax on US-source investment income cannot be obtained. Once listed, a UK charity's only alternative is to file a request for reinstatement on Form 1023 (the briefer Form 1023-EZ is not available), and seek to demonstrate a reasonable basis for its non-filing of information returns if it wishes to obtain retroactive reinstatement, under procedures set forth in Revenue Procedure 2014-11.

What are the costs and benefits of reinstatement?

For those UK charities interested in attracting donations from US citizens (including the many who are resident in this country) and donor-advised funds, or grants from US private foundations, the benefits of reinstatement are apparent. While US individuals interested in benefiting UK charities customarily donate to 'American Friends of' charities, those intermediaries will need to demand an accounting from any listed UK charities to which they make on-grants. Moreover, US private foundations will be dissuaded by the need to exercise 'expenditure responsibility' over grants to listed UK charities. Finally, a simple bequest to a listed UK charity in the UK will of a US citizen resident here will fail to be excluded in computing his or her taxable estate (for US purposes) – a defect which will probably be noticed only after death, when the executor prepares the US estate and gift tax return.

For those UK charitable endowments which do not seek US support but wish to minimise US withholding tax on investment income (which is not creditable against UK tax), the cost of revocation can be calculated in terms of excess withholding tax on US dividends (15% versus 4% for private foundations and zero for public charities) and on gains on unleveraged US real property (up to 39.6% for UK charities in trust form and 35% for those in corporate form versus zero for both).

The costs of reinstatement comprise not only the professional fees for completing Form 1023 and the filing fee of $850, but also a penalty for the failure to file information returns in the intervening years and the prospective filing ad infinitum of the annual information return on Form 990, 990-EZ, 990-N, or 990-PF, as applicable. If retrospective reinstatement is sought, the charity must create and file information returns for the three missing years (the earliest would be 2007 to 2009) and for all subsequent intervening years (2010 to 2016), and prepare a statement establishing its 'reasonable cause' for failing to file the three information returns. If granted, the failure to file penalty (which is normally $10,000 per year but can rise to $50,000 per year for the largest charities) will be waived (IRC section 6652(c)(1)(A)).

There may be a silver lining in seeking retroactive reinstatement for those UK public charities which have been unaware of their entitlement to zero US withholding tax on dividends. These should be able to claim a refund of withholding tax on their dividend income for at least some of the intervening years, if they achieve retroactive reinstatement.

In weighing alternatives, the costs of reinstatement should be compared with the cost to a listed UK charity of doing nothing, which includes liability for the failure to file penalty (should the IRS seek to collect it across the Atlantic) and the filing of any required US tax returns as a *taxable* non-US entity to report underwithheld US-source investment income for the intervening years and in future.

Action plan

1. Most importantly, every UK charity interested in the US should check whether it is included on the list of revoked charities on the IRS website.
2. If they do not appear there, they should continue as is but ensure that they file any required annual US information return, if they are not already doing so. It would be very unlucky if an initial filing of an annual information return led to an IRS inquiry, given that the purpose of the 2006 legislation would have been served.
3. If the UK charity finds its name on this list, it must consider whether the costs of reinstatement outweigh the benefits. In our experience, reinstatement is usually favoured.
4. The UK charity must then consider whether it should seek prospective or retrospective reinstatement. Prospective is cheaper and simpler, but the interim period of revoked status will be problematic if the charity received material gifts or investment income from the US during it. Retroactive reinstatement will require additional professional fees, but once obtained leads to an uninterrupted history of US tax exemption, which is much simpler for US donors and withholding agents, and does not require the UK charity to pay failure to file penalties or US withholding tax on investment income earned in the interim. ■

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