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The Effect of Tax Reform on Exempt Organizations

While the Tax Cuts and Jobs Act of 2017 (“Act”) was largely focused on individual and for-profit corporate taxpayers, there are still provisions therein which will either directly or indirectly impact a good number of exempt organizations.

Please find following a summary of the most impactful provisions in the Act which could directly impact various types of exempt organizations (all of the provisions referenced below are first effective January 1, 2018 unless otherwise set forth):

- For exempt organizations which compensate an executive (for example, Executive Director) more than $1,000,000 annually, such exempt organizations will be subject to a 21% excise tax on the excess amount of compensation over $1,000,000. This excise tax, payable by the exempt organization itself, is applicable to the five highest compensated executives of the organization.

- For those exempt organizations which are subject to the unrelated business income tax, the tax rate has been reduced from 35% to 21%. Additionally, as applicable to those exempt organizations subject to the unrelated business income tax, net operating loss carrybacks will no longer be permitted, however, net operating loss carryforwards will no longer expire at any point in time (previous law caused such to expire in 20 years). Finally, net operating loss carryforwards will only be able to offset 80% of total unrelated business income in a given year.

- Regarding unrelated business losses which an exempt organization generates, going forward, only the unrelated business loss generated from a particular activity will be permitted to offset income from that same particular activity; losses generated from one unrelated activity will no longer be permitted to offset income from another unrelated business activity.
The Effect of Tax Reform on Exempt Organizations (cont.)

- For certain colleges and universities, an excise tax (1.4%) on their net investment income will be imposed; this excise tax is only expected to be initially applicable for the 30 largest private colleges and universities in the United States.

Next, please find following a summary of the most impactful provisions in the Act which could indirectly impact various types of exempt organizations (all of the provisions referenced below are first effective January 1, 2018 unless otherwise set forth):

- For all individual taxpayers, the standard deduction (taken on the Form 1040 in lieu of a taxpayer itemizing their deductions) has essentially been doubled. It is estimated that this law change will result in a reduction of those itemizing their deductions on the Form 1040 from approximately 30% to 5%; accordingly since far less individual taxpayers will be itemizing their deductions, it is estimated that there will be an annual decrease in contributions to charitable organizations of about $20 billion.

- Regarding the estate and gift tax, the lifetime exemption amount has been doubled, it is believed that there will be an annual decrease in contributions to charitable organizations of about $5 billion.

- Going forward, there is now a denial of a charitable contribution deduction to individual taxpayers when they make a contribution to a college or university if such entitles the donor to purchase tickets to university sports events; under previous law, an 80% charitable contribution deduction was permitted in this situation.

- In regards to the individual charitable contribution deduction, the new law increases the annual charitable contribution deduction limitation from 50% to 60% of an individual taxpayer’s adjusted gross income; there is no corresponding increase in the annual adjusted gross income limitation (30%) when capital gain property is contributed to a charitable organization.

Finally, please find following various provisions which did NOT make their way into the final legislation and as such, are NOT provisions which exempt organizations need be concerned with (for now!):

- Applicable to charitable organizations, the Johnson Amendment was NOT repealed; this provision was initially enacted back in 1954 and sets forth that charitable organizations are not permitted to undertake any sort or amount of political activities; since the Johnson Amendment was not repealed, as of today, charitable organizations still are not permitted to undertake political activities.

- The private foundation net investment income tax brackets have NOT been altered as the existing alternative tax brackets (1% / 2%) remain in place; it had been proposed to replace the two alternative brackets with just one 1.4% tax bracket for a private foundation’s net investment income.

Ping Ponged – §501(c)(3) Organization Not Exempt from Oregon Property Taxes

A 501(c)(3) ping pong club is not exempt from real estate tax as a charitable organization, a Magistrate of the Oregon Tax Court, has ruled. He has held that the club did not meet the state’s definition of a charity. The Willamette Table Tennis Club rented space at a bargain rent of $100 per year and agreed with the landlord that it would apply for real estate tax exemption. It was organized as a mutual benefit corporation. Its articles of incorporation said it was organized for educational purposes and to foster table tennis among its members. It was a member of the United States Table Tennis Association, teaching and promoting table tennis to children and the public.

The Marion County Assessor argued that the club could not qualify as a charity because it was organized as a mutual benefit corporation rather than as a public benefit corporation. The club argued that it was educational and had a federal 501(c)(3) exemption. The Magistrate cited state cases holding that a mutual benefit corporation was not organized as a charity and could not be granted charitable exemption. But the Magistrate went further to conclude that it also failed to meet the state requirement of a “gift or giving” in a charitable organization.

The Magistrate cited the club’s website, which offered a free beginner lesson on Mondays and an hour of free play on Thursdays. The Magistrate concluded that such free time was “incidental” rather than a main purpose of the club. The club argued that its website was wrong, but the Magistrate said the argument was “not persuasive because, from the perspective of the public who is looking at its website, playing is not free, and inability to pay is not a consideration.” He concluded that the club had not demonstrated an element of gift or giving. (Willamette Table Tennis Club v. Marion County Assessor, Tax Ct. OR., Magistrate Div. Property Tax, TC-MD 160257R, 7/10/17.)
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Court Rules That These PILOTS Will Fly

In a relatively recently published case, the Florida Supreme Court held that an agreement by a charitable organization to make payments in lieu of taxes ("PILOTs") to a local municipality is not unconstitutional or unenforceable. In this particular situation, an exempt organization (nonprofit developer of low-income housing) had entered into an agreement with the City of Largo after acquiring real property located within Largo in 2000. At such time, the exempt organization developer agreed to make payments in lieu of taxes equal to the taxes it would have to pay if assessed in accordance with the existing real property taxing procedures in Largo. In 2006, the project was transferred to a new charitable owner who refused to make the PILOT payments.

In the case at hand, the Florida Supreme Court ruled that the subsequent owner of the real property was required to make the PILOT payments as had been agreed to by the predecessor owner of the property. Of more significance than the actual ruling in this particular Florida case is that we have noticed a significant increase in states looking to tax exempt organizations in any ways that they can, including through the imposition of indirect taxes such as real property taxes.

Targeting Controversy Settlement

Back a couple of months ago, the Department of Justice announced that they entered into settlements with almost 470 applicants who had sought recognition of tax-exemption under §501(c)(4) back in the early 2010s. It had been alleged that the Internal Revenue Service's review of such Tax Exemption Applications (Form 1024) was significantly delayed based upon the consideration of inappropriate "criteria". The First Amendment prohibits the federal government from treating groups differently based solely on their viewpoint or ideology, but it was alleged that the Internal Revenue Service violated such by using inappropriate criteria to screen Form 1024 Tax Exemption Applications seeking recognition of tax-exemption under §501(c)(4) of the Internal Revenue Code.

Supposedly, the Internal Revenue Service screened Forms 1024 from applicants with names such as “Tea Party,” “Patriots,” or “9/12”. Additionally, it was alleged that the Internal Revenue Service looked at the narrative descriptions of an organization’s exempt purposes and delayed those Applications which contained policy positions concerning government spending or taxes, education of the public to “make America a better place to live,” or statements criticizing how the country was being run.

As a result of this additional scrutiny, the Internal Revenue Service allegedly transferred hundreds of Forms 1024 to a specifically designated group of determinations agents for additional levels of review, questioning and delay. In many instances, the Internal Revenue Service allegedly then requested highly sensitive information from applicants, such as donor information, that was not needed to make a determination of tax-exempt status.

Settlement

Since a CEO for an exempt organization is certainly considered to be an “insider” of the organization, all of this certainly constitutes prohibited private inurement. That being said, the former CEO of the organization will need to pay back all the misappropriated amounts to the charitable organization and also be subject to a stiff penalty excise tax under §4958 of the Internal Revenue Code. Additionally, it is possible that the charitable organization here will lose their recognition of tax-exempt status and it is also possible that the organization’s Board members (notwithstanding the “bogus” Board) could be subject to monetary penalties.

Millions Embezzled by Nonprofit Executives

In a relatively recent story posted on www.mynewsila.com, three former executives of a nonprofit group that provided counseling, job-placement and other services pleaded guilty to embezzling millions of dollars from the organization that received varying amounts of financial support over the years from the city and county of Los Angeles. The former CEO of Chicana Service Action Center, faces the stiffest penalties under a plea deal with prosecutors after pleading guilty to numerous charges. The most serious of the allegations was that the former CEO operated the organization with a “bogus” Board of Directors and spent misappropriated funds on such personal items as luxury apartments, sports cars, cruises and baseball / basketball season tickets.

Since a CEO for an exempt organization is certainly considered to be an “insider” of the organization, all of this certainly constitutes prohibited private inurement. That being said, the former CEO of the organization will need to pay back all the misappropriated amounts to the charitable organization and also be subject to a stiff penalty excise tax under §4958 of the Internal Revenue Code. Additionally, it is possible that the charitable organization here will lose their recognition of tax-exempt status and it is also possible that the organization’s Board members (notwithstanding the “bogus” Board) could be subject to monetary penalties.

Please do not hesitate to contact Brian Yacker at 310-982-2803 or at byacker@yhadvisors.com if you have any questions regarding the foregoing or if you need any additional information whatsoever regarding the exempt organization tax, legal and accounting services which YH Advisors provides.
FOCUS on the IRS TE/GE DIVISION

IRS 2018 EO Work Plan

Every year, the TE/GE Commissioner (currently Sunita Lough) issues a Work Plan for the upcoming year (2018 in this case) which summarizes the accomplishments of the past year (2017 in this case) and sets forth the focus of TE/GE in the coming year.

Regarding the 2017 Accomplishments for TE/GE:

- TE/GE modified certain eligibility criteria for the Form 1023-EZ (see Rev. Proc. 2017-5) so that organizations exempt under a subsection other than §501(c)(3) are no longer eligible to use Form 1023-EZ to apply for recognition of exemption under §501(c)(3). Also, an organization may not submit a Form 1023-EZ if it has submitted a Form 1023 that is pending.

- Realigned the cross-functional Employment Tax Knowledge Network (K-Net) with the other five EO K-Nets. EO K-Nets created issue podcasts (please see https://www.stayexempt.irs.gov/home/resource-library/issue-podcasts) which are short, on-demand presentations that include a summary and analysis of issues as well as references to key resource materials. TE/GE also created and posted new issue snapshots (please see https://www.irs.gov/government-entities/tax-exempt-and-government-entities-issue-snapshots) for charities and nonprofits. These snapshots are aids that provide analysis and resources on technical tax issues.

- Issued proposed adverse determination letters to organizations that did not provide complete responses to requested information regarding a Tax Exemption Application which they filed with the Internal Revenue Service.

- TE/GE continued to process Form 8976, Notice of Intent to Operate Under Section 501(c)(4), for proposed §501(c)(4) organizations to submit their notice of intent-to-operate-under-§501(c)(4). Since implementation, 17% of the Forms 8976 were rejected by the Internal Revenue Service. The most common reasons for rejection were non-payment of the user fee and pre-existing exemptions (so Form 8976 was not required).

- EO Examinations welcomed specialists from the Federal, State, and Local (FSL) government function. The addition of these specialists allows EO to leverage and centralize TE/GE’s employment tax knowledge and achieve efficiencies in examining employment tax issues.

Regarding the 2018 Work Plan:

- EO expects to receive an increased number of Tax Exemption Applications in 2018. As a result of this, EO expects the average processing time for a Form 1023-EZ to increase. EO will continue pre-determination reviews of a statistical sample of Form 1023-EZ applications and will continue to analyze the data from these applications to mitigate risks and identify opportunities to improve this form and its instructions.

- EO will continue to produce high-quality technical products (e.g., issue snapshots and audit tools) and integrate the K-Nets with new Compliance Strategies. Planned topics include issues involving gaming, unrelated business income (and related exemption issues), IRC section 501(r), organizational test requirements and employment taxes. EO will also continue to work on removing technical information, such as summaries of Revenue Rulings and court cases, from the Internal Revenue Manual and placing them on the Audit Technique Guides (ATGs) for Exempt Organizations webpage (https://www.irs.gov/charities-non-profits/audit-technique-guides-atgs-for-exempt-organizations).

- TE/GE intends to focus upon the following compliance strategies:
  - Examine entities that state they are supporting organizations and filed the Form 990-N.
  - Examine organizations that operated as for-profit entities prior to their conversion to §501(c)(3) organizations.
  - Examine organizations which show indicators of potential private benefit or inurement to individuals or private entities.
  - Continue to improve Form 990, 990-EZ, and 990-PF compliance models.
  - Continue to examine private foundations based on potential anomalies found on their Form 990-PF filings.
  - Continue to pursue referrals received from sources within and outside the IRS that allege non-compliance by an exempt organization.
  - Continue to address requests for refunds or credits of overpayments of amounts already assessed and paid, including tax, penalties, and interest or an adjustment of tax paid or credit not previously reported or allowed.
  - Examine entities that filed and received exemption using the Form 1023-EZ. In addition, EO will examine entities that were granted exemption through the streamlined review of their Form 1023.
  - Examine returns filed by exempt organizations to ensure comprehensive compliance coverage of this universe.

- EO will continue to use compliance checks to determine whether an entity is adhering to recordkeeping and information reporting requirements.
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Much Needed Additions for the Form 1023-EZ

Recently, in the periodic Exempt Organizations Newsletter which the Internal Revenue Service distributes on a complimentary basis, the Internal Revenue Service announced changes that were recently made to the streamlined Tax Exemption Application, the Form 1023-EZ:

- A text box was added to Part III of the Form 1023-EZ requesting a brief description of the organization’s mission or most significant activities; this change was recommended by the IRS National Taxpayer Advocate and is designed to provide a better understanding of the most significant activities that an organization engages in to further its exempt purposes.

- Questions about annual gross receipts, total assets and public charity classification were also added to the Form 1023-EZ; these questions are also on the Form 1023-EZ Eligibility Worksheet in the Instructions that organizations must certify they have completed.

- Question 29 on the Form 1023-EZ Eligibility Worksheet now requires that an automatically revoked organization applying for reinstatement must seek the same foundation classification they had at the time of automatic revocation to be eligible to use the Form 1023-EZ; organizations that are not seeking that same foundation classification must file a full Form 1023.

These revisions to the Form 1023-EZ make it easier for organizations to select the correct Form when applying for tax-exempt status and help the Internal Revenue Service make the correct determinations on tax-exempt status. Predictably, the Form 1023-EZ Instructions have also been revised / updated. The revised Instructions are similar to the current Instructions with two major changes. One, Part III, Your Specific Activities, directs applicants to describe their exempt purpose activities. The Instructions give applicants three examples of activities that pass muster under §501(c)(3) and three examples that do not (generally because of more than incidental private benefit). The revised Instructions also try to better explain Foundation Classification in Part IV.

Finally, regarding Tax Exemption Applications in general, effective January 1, 2018, the user fee for the Form 1023 has been lowered to $600 while the user fee for filing the Form 1023-EZ remains the same at $275.

Introduction of Form 1024-A

On September 28, 2017, the Internal Revenue Service released a draft of Form 1024-A, Application for Recognition of Exemption Under Section 501(c)(4). Such draft of the Form 1024-A included the following Parts for applicants seeking recognition of tax-exemption under §501(c)(4) of the Internal Revenue Code:

- Part I – Identification of Applicant
- Part II – Organizational Structure
- Part III – Narrative Description of Activities
- Part IV – Officers / Directors / Employees / Independent Contractors
- Part V – Specific Activities
- Part VI – Financial Data (including Income Statement and Balance Sheet)
- Part VII – Annual Filing Requirements
- Part VIII – Section 506 Notice
- Part IX – User Fee Information

Audit Technique Guides

Audit Technique Guides help Internal Revenue Service examiners during audits of specific types of exempt organizations. While Audit Technique Guides are technically designed to provide guidance for IRS employees (for example, revenue agents), they are also very useful resources to the staffs and governing boards of exempt organizations as well as the tax practitioners who work with them. Audit Technique Guides recommend specific examination techniques, explain specialized business practices and terminology, and explore issues common to certain types of exempt organizations (for example, public charities).

Please note that the material in the Audit Technique Guides is drawn from the former Internal Revenue Manual (“IRM”), specifically Section 4.76 of the IRM which was removed from the IRM in September 2017. For uniformity and consistency with other parts of the IRM, the IRS moved the technical guidance information formerly found in this IRM to the Audit Technique Guides.
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New Web Design for the IRS

In case you haven’t noticed, the Internal Revenue Service’s web site has changed. Significantly. The new IRS home page does not appear to have any reference to Exempt Organizations. But if you click on Menu, there is a listing for Charities & Nonprofits. Clicking on that gets you to Tax Information for Charities & Other Non-Profits.

From a “big picture” perspective, please find following some of the revisions/updates to the Internal Revenue Service’s web site:

- One of the most important updates is that the IRS’s web site is more mobile friendly; as such, the site will now resize and adapt based on the size of the viewer’s screen or the type of device they are using, including smartphones, laptops, tablets or desktops.

- The Internal Revenue Service also improved the way their content is organized, highlighting important tasks. Users can find information about top tasks when you click on the File, Pay, Refunds, Credits & Deductions, and Forms & Instructions links at the top of every page on the Internal Revenue Service web site. Users can also hover their mouse over these links to reveal new drop-down menus. Each drop-down menu groups popular content options to eliminate scrolling – giving users quicker access to the information they need.

- Additionally, the Internal Revenue Service added several links to the top of every page that will give users one-click access to their help page, news center, content in other languages, information for charities and nonprofits and resources for tax professionals.

IRS Reports on Non-Cash Contributions

In the Summer 2017 issue of the Statistics of Income Bulletin, the Internal Revenue Service set forth the results of a study they conducted regarding non-cash contributions. The Statistics of Income Bulletin is issued quarterly by the Statistics of Income Division of the Internal Revenue Service. The report provides the earliest published annual financial statistics obtained from the various types of tax and information returns filed, as well as information from periodic or special analytical studies of particular interest to students of the U.S. tax system, tax policymakers and tax administrators.

Regarding the non-cash contributions study, it was reported therein, for tax year 2014, individual taxpayers who itemized deductions reported a total of $65.3 billion in noncash charitable contributions on a total of 22.2 million individual tax returns. About a third (8.0 million) of these returns reported $60.4 billion in charitable contribution deductions using Form 8283, Noncash Charitable Contributions. Individual taxpayers use this form when the amount of taxpayer deductions for all noncash donations on Schedule A, Itemized Deductions, exceeds $500.

The number of individual returns filed by taxpayers with a Form 8283 attached increased 3.9 percent, from 7.7 million for Tax Year 2013 to 8.0 million for Tax Year 2014. Total donations decreased 30.1 percent for 2014, up from $46.4 billion for the previous year. Corporate stock donations increased 48.0 percent from $19.7 billion for 2013 to $29.2 billion for 2014, while easements more than doubled to $3.2 billion.

Corporate stock accounted for the largest amount and percentage ($29.2 billion, 48.4 percent) of taxpayers’ total noncash charitable contributions for 2014, followed by clothing ($10.3 billion, 17 percent) and household items ($5.0 billion, 8.2 percent). Only about 160,000 returns included stock donations, compared to 6.1 million returns with clothing donations and 3.2 million with donations of household items. The average corporate stock donation, however, was $183,200 per return, while the average donations for clothing ($1,674 per return) and household items ($1,567 per return) were much smaller. In comparison, the highest average donation amount per return was for easements, followed by other investments (excluding corporate stocks or mutual funds). Slightly more than 3,200 returns had donations of easements totaling $3.2 billion, or $983,651 per return, and approximately 5,685 returns had donations of other investments totaling $1.9 billion, or $325,647 per return.

Donation amounts changed between 2013 and 2014 for several categories of noncash assets. The most notable positive percentage changes occurred in easements, increasing from $1.1 billion in 2013 to $3.2 billion in 2014 (194.9 percent), corporate stock, increasing from $19.7 billion in 2013 to $29.2 billion in 2014 (48.0 percent), and mutual funds, increasing from $1.6 billion in 2013 to $2.1 billion in 2014 (29.1 percent). The most notable negative percentage changes occurred in other investments (-17.0 percent) and real estate (-11.6 percent). While these percentage decreases were large, their overall significance is muted by the fact that their share of the overall donation amount was small. Combined, they represented only 5.0 percent of the total 2014 donation amount.

Please find following the listing of the most prominent types of non-cash property donated to charitable organizations during the 2014 tax year:

- **Accessories**—Includes belts, furs, jewelry, purses, scarves, and watches.
- **Art and collectibles**—Includes art works, such as ceramics, drawings, paintings, photographs, and sculptures; and collectibles, including coins, books, historical documents, memorabilia, rare or valuable clothing, jewelry, and stamps.
- **Cars and other motor vehicles**—Includes vehicles designed for road transportation, such as cars, buses, motorcycles, motor homes, SUVs, and trucks.
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- **Clothing**—Includes apparel for children, men, and women, such as coats, dresses, hats, shoes, and suits. Also includes sports and school uniforms.
- **Conservation easements**—Includes land and right-of-way easements. Donations of this type must be a qualified real property interest contributed to a qualified organization for conservation purposes.
- **Corporate stock**—Includes shares of publicly traded and closely held common and preferred stock, as well as stock rights.
- **Electronics**—Includes cameras, computer systems, copiers, DVD players, fax machines, stereo systems, televisions, telephones, and video games.
- **Façade easements**—Includes real estate easements and historical preservation or architectural easements.
- **Food**—Includes beverages, individual food items or meals, snacks, restaurant coupons, vitamins, and wine.
- **Household items**—Includes appliances, books, exercise equipment, furniture, luggage, tools, and toys.
- **Intellectual property**—Includes copyrights, patents, trademarks, trade names, trade secrets, and certain types of software.
- **Land**—Includes farms, orchards, and open lots.
- **Mutual funds**—Includes shares of taxable and nontaxable mutual funds, exchange-traded funds, and unit investment trusts.
- **Other investments**—Includes annuities, bonds, certificates of deposit (CDs), life insurance policies, notes, options, partnership interests, and real estate investment trusts.
- **Planes, boats, and other vehicles**—Includes all-terrain vehicles, airplanes, and watercraft vehicles, such as boats, canoes, ships, and waterskis.
- **Real estate**—Includes apartments, cabins, houses, and other residential and commercial property.
- **Services**—Includes audio presentations, catering, healthcare services, transport and travel expenses, tutoring, and other professional services.
- **Other**—Includes animals, building materials, cemetery plots, medical equipment, tickets to events, and donated vacations or use of vacation property.

**Issued/Proposed EO Guidance**

- **Rev. Proc. 2017-53**—provides guidance regarding §506 of the Internal Revenue Code which is a new Section of the Internal Revenue Code which addresses the required Notice to be provided by “new” §501(c)(4) organizations.

- **IRS Notice 2017-73**—addresses what the Internal Revenue Service is currently considering regulating regarding donor advised funds:

  In early December 2017, the Internal Revenue Service issued IRS Notice 2017-73, which provides a good “road map” regarding what the Internal Revenue Service believes are the most prominent donor advised funds “hot buttons” for them to scrutinize in the near future. IRS Notice 2017-73 provides the general public until March 5, 2018 to forward their comments to the Internal Revenue Service regarding how the Internal Revenue Service is proposing to focus on donor advised funds.

  Specifically, in IRS Notice 2017-73, the Internal Revenue Service is proposing to focus on the following three issues:

  1. The IRS is proposing even harsher rules on donor advised funds than currently applicable to private foundation in the situation where the donor advised fund makes a grant to a charitable organization and the donor advised fund receives back a ticket to the charitable organization recipient’s event and such ticket is used by the creator of the donor advised fund. Please be aware that §4967 of the Internal Revenue Code imposes an excise tax upon a donor who receives more than an “incidental benefit” in connection with an advised gift from a donor-advised fund. That being said, the IRS is proposing to treat the ticket received by the creator of the donor advised fund as being a more than incidental benefit, and as such, subject to the §4967 penalty.

  2. In regards to pledges fulfilled by a donor advised fund, the Internal Revenue Service is here suggesting that, generally, where a donor makes a pledge to a charitable organization which is then subsequently fulfilled by the donor advised fund, such situation will generally not be considered a situation where a more than incidental benefit has been provided to the donor (and thus, no excise tax would be triggered under §4967 of the Internal Revenue Code).

  3. This issue addresses the public charity public support test; specifically the situation when a donor advised fund is making grants to a public charity in danger of failing their applicable public support test if the public charity had received the contribution from the donor as opposed to the donor advised fund; in such instances, the IRS is proposing that for public support purposes only, that they would look through the donor advised fund to its donor and treat that donor as though they had made the contribution to the public charity.
PLR 201749012 – §501(c)(3) organization had their tax-exemption revoked for not being able to produce contemporaneous records to substantiate solicitation of grant funds, the intended use of the funds solicited and its approval process. Specifically, the organization was making grants to various individuals, however it was unable to produce any records or documentation that it had ensured that their granted funds had been utilized charitably.

PLR 201746027 – §501(c)(5) applicant denied recognition of tax-exempt status since applicant (who was engaged in the sale of commercial egg graders) made regular distributions of profits to members; such members also controlled the Board of Directors of the organization; the applicant did not meet the requirements of Reg. §1.501(c)(5)-1(a) in that their net earnings inured to the benefit of their Board members (insiders) and they were not bettering the conditions in agricultural pursuits; additionally, they sold merchandise and provided services for a fee with the net proceeds being distributed to the governing body members.

PLR 201743019 – §501(c)(3) applicant which held an annual fishing tournament for military service members was denied recognition as a tax-exempt organization by the Internal Revenue Service because the Internal Revenue Service determined that the applicant’s activities were specifically focused on social and recreational endeavors (for example, the conducting of a fishing tournament).

PLR 201743018 – applicant under §501(c)(3) of the Internal Revenue Code was denied recognition of tax-exemption; such applicant was proposing to operate a pharmacy; they were denied recognition of tax-exemption by the Internal Revenue Service because the Internal Revenue Service determined that the applicant’s pharmacy operations competed directly with for-profit enterprises and was operated in a commercial manner; in this particular situation, the pharmacy did not provide any of their services at below cost.

PLR 201736027 – in this situation, a condominium association was denied §501(c)(4) status by the Internal Revenue Service as a result of the fact that such organization was not operated exclusively for the promotion of social welfare since it was operated primarily for the benefit of their association members by managing, maintaining, and caring for property commonly owned by their members; in effect, the sole beneficiaries of their activities were the unit owners (members of the §501(c)(4) organization).

PLR 201736024 – this denial of tax-exempt status is notable in that it is one of the first ones we have seen where a Form 1023-EZ applicant was denied recognition of tax-exemption under §501(c)(3) of the Internal Revenue Code; in this particular instance, the Internal Revenue Service denied §501(c)(3) status to the applicant because its primary activity was deemed to be the conducting of an annual car show for its members and the general public; the Internal Revenue Service received this information from the applicant during a pre-determination review of the applicant’s Form 1023-EZ, it is important to note here that the Internal Revenue Service does NOT conduct very many of these pre-determination reviews of a Form 1023-EZ.
**YH CASE STUDIES**

**Federal Reinstatement Utilizing the Form 1023-EZ**

An exempt organization might unfortunately lose its tax-exempt status for various reasons; the most common being having their exempt status automatically revoked because the organization fails to file its annual return (some version of the Form 990) with the Internal Revenue Service for three consecutive years. The automatic revocation for failure to file annual information tax returns occurs by operation of law and there are no exceptions. Once this happens, the only method of regaining tax exempt status is by filing a Tax Exemption Application with the Internal Revenue Service. This can be accomplished by filing either the Form 1023, Form 1023-EZ or the Form 1024.

Generally, the effective date of the reinstatement will be the date the exempt organization’s Tax Exemption Application was submitted to the Internal Revenue Service. However, the organization may choose to request that reinstatement be retroactive to the effective date of the revocation. The organization will need to meet certain criteria for the reinstatement to be effective retroactively.

Please find following a summary of which version of the Tax Exemption Application a revoked organization should prepare to have their tax-exempt status reinstated.

**Form 1023 EZ:** Only certain organizations are eligible to apply for the exemption under §501(c)(3) using Form 1023-EZ. The Form 1023-EZ eligibility worksheet is recommended to be completed to determine if the organization is eligible to use this form. One of the most important criteria is to meet the annual gross receipts threshold. The annual gross receipts of the exempt organization cannot exceed $50,000 in any of the past 3 years or the next 3 years in order to be eligible for Form 1023-EZ.

**Form 1023:** Exempt organization who are not eligible to file the Form 1023-EZ will need to file the full Form 1023 to apply for exemption under §501(c)(3). Organizations organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition, or for the prevention of cruelty to children or animals are eligible to apply for exemption under §501(c)(3).

**Form 1024:** Exempt organizations who are not eligible to file Form 1023 or Form 1023-EZ can file Form 1024 to apply for recognition of exemption under §501(a).

Please do not hesitate to contact Ruby Pradhan at 310-982-2833 or at rpradhan@yhadvisors.com if you have any questions regarding the unrelated business income rules and Regulations for exempt organizations.
YH QUICK TIPS

Private Foundation Excise Tax Abatement

Notwithstanding the fact that the following is not universally known, for a private foundation that is subject to the imposition of an excise tax (NOT including the self-dealing excise tax imposed under §4941 of the Internal Revenue Code), such private foundation should be made aware of §4962 of the Internal Revenue Code. Section 4962 sets forth that for any qualified first-tier penalty excise taxes to be abated, credited or refunded, the following must be established:

1. The excise tax liability was due to reasonable cause and not to willful neglect, and
2. Such event (which led to the excise tax being imposed) was corrected within the applicable correction period.

Although there are no Treasury Regulations under §4962, there are various other Regulations in Chapter 42 which provide guidance regarding how “reasonable cause” should be defined. In those instances when the private foundation (or a foundation manager) can establish that there was reasonable cause for a violation and that there was no willful neglect of the rules, the Internal Revenue Service has discretionary authority to relieve the private foundation (or the foundation manager) from the first-tier penalty excise tax, provided that the violation is corrected in the manner required in order to avoid liability for second-tier taxes. A violation which was merely due to ignorance of the law cannot qualify for such abatement.

In United States v. Boyle (469 U.S. 241, 1985), the Court held that to show reasonable cause, the taxpayer must demonstrate that he exercised “ordinary business care and prudence.” The failure to make a timely filing of a tax return is not excused by the taxpayer’s reliance on an agent (for example, CPA) and such reliance is not “reasonable cause” for a late filing. It requires no special training or effort on the taxpayer’s part to ascertain a deadline and ensure that it is met. In Woodsum v. Commissioner (136 T.C. 585, 2011), the Court determined that there was no reasonable cause for the failure to report $3.4 million in income when the taxpayer had provided its tax preparer with all of the information for it to know that the taxpayer had earned that income.

Further, in Thorne v. Commissioner (99 T.C. 67, 1992), the Court found that the taxpayer made numerous grants to organizations that were not tax exempt, that he did not exercise expenditure responsibility over grants made and that he made grants to friends and relatives for personal purposes. Accordingly, the Court ruled that the taxpayer failed to exercise his responsibility with ordinary business care and prudence and acted without reasonable cause. Finally, in de Belaieff v. Commissioner (15 T.C.M. 1426, 1956), the Court held that ignorance of the law does not constitute reasonable cause.

Please do not hesitate to contact Brian Yacker at 310-982-2803 or at byacker@yhadvisors.com if you have any questions regarding the foregoing or if you need any additional information whatsoever regarding the extensive services which YH Advisors provides.

YH PRESENTS

“So Now You Know…”

One of the benefits of being a small charitable (§501(c)(3)) organization (annual gross receipts of less than $50,000) is that such organization can avoid the requirement to file the somewhat burdensome Form 990-EZ or the very burdensome Form 990 since the small charitable organization can file the Form 990-N. A Form 990-N filer is not required to prepare any of the different Form 990 Schedules, including Schedule A to calculate their public support test ratio.

However, notwithstanding the fact that a small charitable organization is not required to prepare Schedule A (because they are eligible to file the Form 990-N), it is surprising to many that the small charitable organization is still required to document and prove that they satisfy the applicable public support test, otherwise they will be reclassified as a private foundation if the Internal Revenue Service discovers that they do not satisfy the applicable public support test calculation.

So now you know that even a charitable organization which annually files a Form 990-N with the Internal Revenue Service must still annually compute their public support test ratio in order to document that they still qualify as a public charity.

Please do not hesitate to contact Brian Yacker at 310-982-2803 or at byacker@yhadvisors.com if you have any questions regarding the foregoing or if you need any additional information whatsoever regarding the exempt organization services which YH Advisors provides.
The beginning of each new calendar year provides a good opportunity for an exempt organization to honor and be grateful for their donors, volunteers, staff and those who supported the undertaking and expanding of their important mission. Additionally, there is the opportunity to assess an exempt organization’s plans for continued growth, continued service and continued sustainability by having valuable conversations about the exempt organization’s succession plan.

We so often see grass roots missions developed quickly to support the exempt organization’s target mission without having detailed conversations as to legacy and infrastructure, essentially without discussing a long-term business plan or succession plan. When discussing succession plans, exempt organizations typically assess future leadership opportunities: who will be next in line to manage and run the organization? That then concludes the succession planning conversation in many cases. Exempt organizations have a multitude of opportunities here to ensure long term success and sustainability. It is imperative that the business side of running an exempt organization not be overlooked and a suitable business plan be put in place.

The exempt organization planning discussion should include conversations surrounding the overall infrastructure. What else besides personnel should exempt organizations be assessing and addressing as part of their succession planning discussions? We have compiled a list of financially related best practices for exempt organizations of all shapes and sizes to assess during strategic and business plan discussions as follows:

- **Put a digital archive system in place.** We are well into the digital, paperless era. Embrace it. Scan and save documents electronically. This allows the core of the exempt organization’s operations, finances, policies, procedures, permanent documents, everything to be handed over to the next leadership team of the organization seamlessly. This also protects the exempt organization from loss due to an unexpected disaster (fire, flood, etc.). As an additional benefit, maintaining electronic files will allow the financial management team to access and produce requested documents quicker for financial statement auditors.

- **Discuss cash flow before it is a problem.** Budgets are set at the beginning of a fiscal year based on assumptions and expectations at that time. What happens if things change throughout the year? A major donor decides not to repeat their gift or lessens the amount? A major program must cease due to staffing challenges or legislative burdens? Even just day to day short-comings in cash flow can lead to large scale challenges. Mitigate this risk by having consistent and contemporaneous conversations about cash flows. Schedule monthly or quarterly finance calls and include the exempt organization’s CPA or outside financial advisor to lend an extra set of eyes over things. Addressing noted shortfalls or challenges early in the process will make fixing the problem less painful.

- **Regularly review restricted gifts.** It should go without saying due to the legal requirement to spend gifts in accordance with donors’ wishes, but many exempt organizations do not have a process in place that allows them to track and assess restricted gifts in real time. Creating a workflow that contemporaneously tracks restricted spending will ease the burden of grant reporting as well as audit requirements. More importantly, it will give the management team peace of mind that donors’ wishes are consistently being upheld. At least annually, the finance team and the development team should compare notes regarding restricted gifts as part of this workflow as well.

As we here at YH Advisors have said numerous times before, running an exempt organization is just like running any other business. And with any other business, the infrastructure must be suited to support expected growth in order for successful expansion to continue. Consistent conversations about an exempt organization’s succession plan covering both personnel and the overall infrastructure are imperative in ensuring this is the case.

Please do not hesitate to contact Stacey Bergman at 310-982-2805 or sbergman@yhadvisors.com if you have any questions regarding the foregoing or if you need any additional information whatsoever regarding the exempt organization accounting and attestation services which YH Advisors provides.
How to Get Ready for a Financial Statement Audit

The financial statement audit is an annual rite of passage for many exempt organizations. Oftentimes, the word “audit” is met with dread by many exempt organizations, but it doesn’t have to be that way if the process is well thought-out and planned in advance. In order to have a smooth and successful financial statement audit, we recommend the following approach for getting ready:

**Planning**

Two or three months before the fiscal year end for the exempt organization, a conversation with management, accounting (bookkeeping) staff and the Audit Committee Chair needs to take place to discuss whom within the exempt organization will be supporting the financial statement audit process and the timing of the audit based on deadlines and other timing requirements. It is usually not ideal to schedule a financial statement audit too close to year-end or a big special event.

Subsequent to that internal conversation, the exempt organization should make contact with their auditor (independent CPA) to request an engagement letter and to schedule fieldwork. The exempt organization needs to be sure to communicate any changes that occurred within the organization during the year that had a financial impact or may affect the financial statement audit process. Once the engagement letter has been executed and returned to the auditor, the exempt organization should request an audit request list (preferably in Excel or Word format). Once the request list is received, identify who within the exempt organization will be responsible for what items on the list and when they need to be completed by.

**Year-End Close**

Once the exempt organization’s applicable fiscal year has ended, they need to begin the close process. In addition to the normal bank and credit card reconciliations that are completed during a normal month-end close, the exempt organization will want to reconcile and/or prepare schedules for all the accounts listed on the Statement of Financial Position (Balance Sheet) and certain accounts on the Statement of Activities (Income Statement). This is where using the auditor’s request list in conjunction with the year-end close is helpful because it will let the exempt organization know what schedules need to be prepared for what accounts and give the exempt organization a “jump start” on completing the request list. This is also a good time to gather the other items on the request list that were assigned to other members in the exempt organization.

**Before Fieldwork**

Approximately 2-3 weeks before the start of fieldwork (timing may vary based on the auditor), the exempt organization should send the auditor the requested items and ask that the auditor return their preliminary testing selections to the exempt organization 1-2 weeks before the start of fieldwork.

Once the preliminary testing selections have been received, the exempt organization should begin pulling all the items requested so that everything has been gathered before the auditors arrive on the first day of fieldwork. Sometimes it is helpful to number each testing selection and cross-reference that number to the supporting documents that are pulled as it will help the exempt organization ensure all testing selections have been addressed and the auditor can move quickly through the testing selections with minimal questions.

Successful planning and preparation for the audit will ensure that once fieldwork begins, the process will progress quickly and the exempt organization will arrive at the end of the audit with financial statements issued on time and limited disruptions to the everyday work of the exempt organization.

Please do not hesitate to contact Melissa Roshnaye at 619-600-5310 or mroshnaye@yhadvisors.com if you have any questions regarding the foregoing or if you need any additional information whatsoever regarding the exempt organization accounting and attestation services which YH Advisors provides.
If a California exempt organization happens to lose their tax exempt status in California, then they must get their California tax-exempt status reinstated by the California Franchise Tax Board, otherwise, such organization will be considered a taxable corporation in California. In our experience, the three most commons reasons why an organization’s recognition of California tax-exemption is revoked is as follows:

1. Failure to file the required Statement of Information with California Secretary of State
2. Failure to pay any amounts due to the California Franchise Tax Board
3. Failure to file any past due information tax returns with the California Franchise Tax Board

When an organization’s California tax-exemption has been revoked and such organization has been suspended by the Secretary of State, the organization cannot legally transact business in California, defend, or initiate an action in court, protest assessments, or file a claim for refund of paid amounts. It also loses the right to use its name.

An organization remains suspended with the California Secretary of State until it meets all revivor requirements. Its revoked status can be corrected by filing a California Tax Exemption Application (Form 3500) with the California Franchise Tax Board. The revoked organization is NOT permitted to file the abbreviated California Tax Exemption Application (Form 3500A) to have their California tax-exempt status reinstated.

To apply for reinstatement of their tax-exempt status, an organization must undertake the following:

- File Form 3500 (Sides 1 through 8) with the Franchise Tax Board
- Complete the appropriate Schedule for the specific R&TC section under which the organization claims exemption
- Pay the $25 application fee

A copy of the organization’s Bylaws and Articles of Incorporation are required if such documents have been amended since the tax-exempt status was originally granted by the Franchise Tax Board.

Please see supra for the reinstatement procedures from a federal perspective.

Please do not hesitate to contact Ruby Pradhan at 310-982-2833 or at rpradhan@yhadvisors.com if you have any questions regarding the foregoing or if you need any additional information whatsoever regarding the extensive nonprofit state and local services which YH Advisors provides.

YH RESOURCES, NEWS & UPDATES

The YH EO Resource Alert

As a regular feature of the YH Exempt Org Advisor, we continue to highlight different exempt organization resources free of charge in the public domain. This quarter we are highlighting the release of many new TE/GE Issue Snapshots by the Internal Revenue Service, including the following:

- 05/12/2017  Volunteer Labor Exclusion from Unrelated Trade or Business
- 05/24/2017  Identification and Treatment of Income from Mailing Lists
- 06/16/2017  Exclusive Provider Arrangement within Qualified Sponsorship Agreements
- 08/28/2017  IRC Section 4945(h) – Expenditure Responsibility
- 08/31/2017  The Enduring Relevance of Rev. Proc. 71-17 on 501(c)(7) Organizations
- 09/14/2017  Taxes on Investments Which Jeopardize Charitable Purpose
- 10/18/2017  Exclusion of Bingo from Unrelated Business Activity
- 10/18/2017  Rents from Personal Property, Mixed Leases and Rental Exclusion from UBTI
- 10/18/2017  Exclusion of Rent from Real Property from Unrelated Business Taxable Income
- 11/09/2017  Entities Engaged in the Corporate Practice of Medicine
- 11/15/2017  Unrelated Business Income from Debt-Financed Property under § 514

The following is from the Internal Revenue Service’s web site:

“IRS TE/GE Issue Snapshots are not official pronouncements of law or directives and cannot be used, cited or relied upon as such. Issue Snapshots provide an overview of an issue and are a means for collaborating and sharing knowledge among IRS employees. Issue Snapshots may not contain a comprehensive discussion of all pertinent issues, law or the IRS’s interpretation of current law. Issue Snapshots do not limit an IRS examiner’s ability to use other approaches when examining issues. Issue Snapshots and any non-precedential material (e.g., a private letter ruling, determination letter, or Chief Counsel advice) that may be referenced in an Issue Snapshots may not be used or cited as precedent.”
YH RESOURCES, NEWS & UPDATES

YH Presentations

Please find following a listing of the presentations which YH Advisors has presented, or will present, during the August 2017 – December 2017 time period. Please do not hesitate to contact us for more information if you have interest in receiving the presentation materials or attending any of the upcoming presentations.

Nov 2, 2017 | Tustin, CA
Legal Fundraising Issues

Nov 7, 2017 | Appleton, WI
Nonprofit Financials

Nov 8, 2017 | Appleton, WI
Form 990 Schedules

Dec 7, 2017 | Portland, OR
Form 990 Tax School

Dec 8, 2017 | New York, NY
Form 990 Webcast (AICPA)

Dec 11, 2017 | New Orleans, LA
Nonprofit Financials

Dec 12, 2017 | New Orleans, LA
Form 990 Core Form

Jan 16, 2018 | Long Beach, CA
Form 990 Workshop

Jan 26, 2018 | San Diego, CA
How to Remain in the Good Graces of the IRS and AG

Jan 27, 2018 | San Diego, CA
Using Your Financials and Form 990 for Storytelling Purposes

Feb 20, 2018 | Newport Beach, CA
How Hospital Auxiliaries Can Avoid the Ire of the IRS

Feb 22-23, 2018 | Baltimore, MD
TE/GE EO Conference

Feb 28, 2018 | Webinar (AICPA)
Executive Compensation

Mar 1, 2018 | Long Beach, CA
The New Tax Act as Applicable to Nonprofits

Mar 23, 2018 | Washington DC
IRS Audits and Exams: Report from the Trenches

Apr 3, 2018 | Irvine, CA
Nuts & Bolts of Exempt Organizations

Apr 12, 2018 | New Orleans, LA
The Best Accounting Software for Nonprofits

Upcoming YH Webinars

YH Advisors will continue to periodically conduct (about 6 times per year) 100-200 minute interactive technical webinars focusing on the tax, legal and accounting issues most relevant to exempt organizations. Please find following our upcoming YH Webinar schedule (please be aware that this is of course subject to change):

March 2018
The Ins and Outs of Contributions Revenue, Part II

April 2018
2018 EO Accounting & Tax Update

June 2018
25 Ways to Lose Your Tax Exemption

August 2018
Private Foundations
Offsite Presentations

Approximately a half dozen times a year, YH Advisors is engaged to provide customized exempt organization tax, legal and/or accounting presentations to a firm, association or company. For example, in 2017, YH Advisors conducted a full-day nonprofit accounting presentation for a CPA firm located in on the East Coast and also conducted a two-hour presentation for a California private foundation regarding how to interpret an exempt organization’s financial statements and Form 990.

Additionally, in the past, we have conducted full-day customized presentations (for which CPE can be awarded) for firms, associations or companies in the following subject areas:

- Form 990: What You Need to Know
- Form 990: The Schedules
- Form 990-PF Primer
- Advanced Private Foundations Issues
- The Unrelated Business Income Tax
- Advanced Exempt Organization Issues
- Nonprofit Accounting, Part I
- Nonprofit Accounting, Part II

Finally, we can conduct shorter presentations (half-day, 2 hours, 60 minutes) for which CPE can be awarded for firms, associations or companies in the following subject areas (certainly not an all-inclusive listing):

- Reporting of Special Events
- The Schedule A Public Support Test
- What Charity Board Members Need to Know
- Tax & Legal Issues for 501(c)(6) Business Leagues
- How to Avoid the Ire of the IRS + Attorney General

YH Webinar Recordings Available to Purchase

To date, we have conducted 33 different exempt organization webinars. We record each of the webinars which we conduct and we are now making each of our webinar recordings available for purchase. Please find following a listing of each of the different webinar recordings which we have available for purchase:

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<th>#</th>
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YH RESOURCES, NEWS & UPDATES

YH Webinar Recordings Available to Purchase

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Next Issue of the YH Exempt Org Advisor

The Spring 2018 edition of the YH Exempt Org Advisor will be published in late May of 2018 after we have emerged from the ultra-busy May 15 Form 990/Form 990-PF filing deadline.