New Year, New Rules: A Look at Recent and Critical Tax Changes for Nonprofits and IRS Enforcement Priorities in 2021

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To say that 2020 was a year that brought about many changes would be an understatement, and many pandemic-related changes applied to for-profit and nonprofit organizations alike. This is particularly true with respect to aid programs. Many of these topics have been written about extensively already, and while important, there were a number of changes unrelated to the pandemic that impacted nonprofits last year or will begin to impact them in 2021. This post provides a brief summary of some of these changes.

Electronic Filing

While electronic filing of some tax forms has been available for quite some time—for example, filing Forms 1099-MISC or 1023-EZ—a number of nonprofit-specific filings moved online in 2020 or will be moving online in 2021.

For new nonprofits, the most immediately noticeable change is the requirement that all Form 1023 applications be filed online through the pay.gov website. This change will likely benefit those applying for tax exemption under Section 501(c)(3), as the move to online filing should reduce application processing time. Online filing of the Form 1023 became mandatory beginning January 31, 2020, although a 90-day grace period was allowed.

Some organizations seeking exemption under Section 501(c)(4) have been required to file Form 1024-A for some time. Beginning January 5, 2021, this form has been amended to allow for electronic filing through pay.gov. The IRS is providing a 90-day grace period in which paper applications may be filed; however, electronic filing will become mandatory beginning April 5, 2021.

Electronic filing is also going into effect for a number of other forms. In 2019, Congress amended IRC § 6033(n) to require most exempt

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organizations to electronically file their applicable Form 990 information return (Form 990, Form 990-N, Form 990-T, Form 990-EZ, Form 990-PF) and Form 4720, used to report certain excise taxes under Chapters 41 and 42 of the Internal Revenue Code. This requirement took effect on July 2, 2019, although the forms were not converted to allow for electronic filing by that date.

However, beginning in February 2021, Form 990-T, on which unrelated business income tax is reported, will be converted to electronic format and electronic filing will become mandatory. Electronic filing of Form 4720 is now slated for some time after July 1, 2021, although the electronic version of the form should be available in the spring. Importantly, once electronic filing of Form 4720 is allowed, foundations will no longer be able to file a joint Form 4720.

While Form 990-N is only available for electronic filing, and has always been so, the rollout of electronic filing for the other forms in the series has been slow. Exempt organizations that file either Form 990 or Form 990-PF will be required to electronically file for tax years ending July 31, 2020 or later. Form 990-EZ will be allowed to be electronically or paper filed for tax years ending before July 31, 2021, after which electronic filing becomes mandatory. Additional information regarding the electronic filing requirement, including links to the IRS approved filing provider, can be found on the IRS website.

Perhaps the biggest news in electronic filing for 2021 is a positive for individuals and organizations of all types, both for-profits and nonprofits. The IRS has launched a new platform that can be used by tax professionals. This platform will allow for the filing of Forms 2848 and 8821, each of which is a power of attorney and authorized representative form and can include electronic signatures. The expectation is that this will speed processing times significantly and allow for almost immediate authorization. Electronic signatures and quick processing will be a huge boost to taxpayers and their representatives, as it has historically been common to mail and/or fax forms multiple times before the IRS system is updated, a problem only exacerbated by frequent government shutdowns and the current pandemic.

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Unrelated Business Taxable Income

In 2017, the Tax Cuts and Jobs Act added Section 512(a)(6) to the tax code, requiring exempt organizations with multiple unrelated trades or businesses to calculate unrelated business taxable income ("UBTI") separately for each trade or business. On November 19, 2020, the IRS released an advanced copy of the final regulations addressing this issue.

The IRS will now require exempt organizations to identify each of its separate unrelated trades or businesses by using the first two digits of the North American Industry Classification System ("NAICS") code that most accurately describes the trade or business. If the exempt organization determines that its unrelated trades or businesses use two or more different NAICS codes, each set of codes is treated as an unrelated trade or business for the purposes of calculating UBTI. In the event an exempt organization has investment activity that is subject to the UBTI rules, the investment activities will be treated as a separate unrelated trade or business.

In calculating the UBTI of each unrelated trade or business, the exempt organization must also determine any net operating loss ("NOL") deductions for each line of business. A transition rule is provided for in the final regulations. Under this rule, an organization with NOLs in a tax year beginning before January 1, 2018, and in a tax year starting after December 31, 2017, will deduct the pre-2018 NOLs from total UBTI before deducting any post-2017 NOLs regarding an unrelated trade or business against that same unrelated trade or business. Despite this, the emphasis in the regulations is on maximizing the deduction of post-2017 NOLs, rather than pre-2018 NOLs, in a given tax year.

In the event an unrelated trade or business that had previously generated NOLs is sold, terminated, or otherwise disposed of, the NOLs will be suspended. Suspended NOLs can be used in the future, however, if the unrelated trade or business resumes or if another unrelated trade or business with the same two-digit NAICS code begins or is acquired. If an unrelated trade or business ultimately changes its NAICS code, the trade or business will be treated as if it was terminated and a new business begun.

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The final regulations contain a number of other provisions relating to a variety of potential income. Any tax-exempt organization with UBTI should become familiar with these rules.

IRS' 2021 Priorities for Tax-Exempt Entities

The IRS issued a letter setting forth its priorities related to exempt entities for the 2021 fiscal year. One focus is to strengthen compliance activities. Increased enforcement will take place with respect to syndicated conservation easements and abusive charitable remainder annuity trusts. The IRS has also indicated that it may increase enforcement of the payment of the excise tax on excess compensation, as it has identified a high volume of exempt organizations that paid compensation of over $1 million to at least one covered employee but failed to report any tax on Form 4720.

The IRS will also focus on increasing voluntary compliance "in the global high-wealth arena," which the IRS has identified as including private foundations and retirement plans of closely held businesses, such as employee stock ownership plans.

In addition to the electronic filing already discussed, the IRS is looking to provide additional online forms and tools. This will include online determination letters and interactive tax assistance tools.

The above are only a few of the changes exempt organizations may be impacted by in the coming year, and more developments will certainly happen as the year progresses. We will continue to monitor any new developments impacting exempt organizations. Visit Frost Brown Todd's Tax Law Defined Blog to get the latest.

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