

**Subject:** Comments on proposed regulations  
**From:** Michael (michael@wexlerlawgroup.com)  
**Sent:** 11/10/2014 3:29 PM  
**To:** scott.chan@doj.ca.gov

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Dear Mr. Chan,

Thank you for the opportunity to comment on the proposed regulations issued in September.

I certainly recognize the need for the Registry of Charitable Trusts to have effective enforcement powers, including cease-and-desist orders and substantial monetary penalties, in case of egregious frauds and abuses by overreaching officers and scam charities. Portions of these proposed regulations are needed to implement Gov't Code section 12591.1.

In my practice, what I run across are small, volunteer-run charities that are doing good work, but sometimes fall short of compliance with of filing requirements of the IRS and half-a-dozen California agencies. As an example, the IRS has automatically revoked the IRC section 501(c)(3) tax exempt status of over 3000 California charities in 2014 (revocation posting date), for failure to file returns for the past 3 years. IRS Form 990-N is still not uniformly understood as a minimal requirement for small charities.

My comments stem from that perspective.

#### 11 CCR 314 Grounds for Imposition of Cease and Desist Order.

1.1 One of the grounds for cease-and-desist orders is filing an incomplete financial report. As I discuss below, Form RRF-1 should be updated to make clear when copies of IRS Form 990, 990-EZ, or 990-PF must be attached, in order to help charities avoid inadvertently filing an incomplete Form RRF-1.

#### 11 CCR 314 Imposition of Penalty.

2.1 "Act or omission" should be defined or illustrated with pertinent examples. For example, if the act being penalized is an improper charitable solicitation, is each letter a separate act? Or is each contribution received a separate act?

2.2 If a penalty is imposed upon conduct of a charity, can the penalty be paid from the funds of that charity, or must it be paid by its directors and officers? In the case of the \$800 minimum franchise tax after revocation of exemption, your office has taken the position that the \$800 must be paid by directors and officers, not from charitable funds. Proposed 11 CCR 999.9.3(b) also indicates that a penalty cannot be paid from charitable funds after a charity has been suspended or revoked by your office. This issue of incidence of the penalty should be covered by the regulation. Moreover, in the case of a non-501(c)(3) organization such as a 501(c)(4) service club, (c)(6) chamber of commerce, or (c)(7) social club that engages in some fundraising to raise money to grant to charities, those organizations would likely have some non-charitable operating funds from which a penalty could be paid.

2.3 The 30-day deadline for payment of the penalty, like the 30-day appeal deadline, should be subject to relief if the charity demonstrates reasonable cause for the delay.

#### 11 CCR 999.6

3.1 Concerning 999.6(c), the 30-day deadline for appeal of an administrative action should be subject to relief if the charity demonstrates reasonable cause for the delay.

#### 11 CCR 999.7 and 11 CCR 999.8 - [no comments]

#### 11 CCR 999.9 Grounds for Refusal, Revocation or Suspension

4.1 Concerning 999.9(a)(3), if a charity is determined upon audit by the IRS or FTB to have made a false or misleading statement or omission in its Form 990 or Form 199, that determination could well serve as grounds for your office to revoke or suspend its registration. The proposed provision is more open-ended, though, and can be read to suggest that your office should be

performing its own audit of Federal or California tax returns. To do so could give rise to inconsistent results, and could place new burdens on OAG staff lacking the requisite training. The scope of this provision is potentially overbroad. If for example a charity misclassifies a worker as an independent contractor rather than an employee -- a recurring issue in both the non-profit sector and for-profit sector -- that would be manifested in incorrect payroll tax filings. Would your office be taking on the role of reviewing worker classification, in parallel to the IRS and EDD? Of course, if your office becomes aware of a questionable item on a tax return, it can already refer that item for consideration by the auditors of the pertinent taxing agency.

#### 11 CCR 999.9.1 Automatic Suspension

5.1 Concerning 999.9.1(a)(1), it is important to distinguish between three causes of suspension or revocation of tax-exempt status. The most serious cause is where after audit the IRS or FTB has revoked exempt status because of malfeasance in operations. Those situations would warrant immediate automatic suspension by your office. The second cause is the far more common situation where a charity fails to file its tax returns for 3 consecutive years and is automatically revoked by the IRS or FTB. Because that failure is often attributable to mere ignorance about Forms 990-N or 199-N, and can often be cured by retroactive reinstatement, this second cause should not trigger automatic suspension by your office. At the very least, your office should provide a month's notice before suspension, as a warning shot. Moreover, if retroactive reinstatement is granted by the pertinent taxing agency, that should retroactively forestall or cancel out all OAG consequences attributable to that revocation; the reinstated charity should provide OAG a copy of all returns and statements filed in order to obtain retroactive reinstatement, but OAG should not require any other IRS or FTB returns. The third cause of FTB suspension or revocation is indirect, due to failure to file biennial reports with the Secretary of State (see 999.9.1(a)(3)) or even with your office, via Rev. & Tax. Code section 23703. Your office should use its discretion here to avoid creating a short-circuit of suspensions.

5.2 Concerning failure to file a complete Form RRF-1 with attached IRS returns (999.9.1(a)(2) ) please consider clarifying and correcting the RRF-1 form and instructions concerning attaching IRS returns. The existing RRF-1 instructions (with a 2005 version date) state that "Charities with total gross revenue or assets of \$25,000 or more must file a copy of the IRS Form 990, 990-EZ, or 990-PF and attachments with the Attorney General's Registry of Charitable Trusts. " The IRS raised its threshold for the 990-N from \$25,000 to \$50,000 of ordinary gross receipts, effective for tax year 2010. Insofar as you intend to require a copy of the 990-EZ only when actually required to be filed with the IRS, please update your instructions, along with Form CT-1 and existing 11 CCR 307. At this point, it would be premature to impose automatic suspension for failure to comply with RRF-1 instructions that are apparently out-of-date.

#### COMMENTS RE NEXT STEPS

To begin with, it is my personal impression that it would benefit the process to extend the comment deadline by at least 2 weeks, in order to allow time to broaden awareness among the nonprofit practitioner community.

Also, I would recommend that before issuing final regulations, your office could take a page from the FTB playbook, and hold an Interested Parties Meeting and teleconference. That format would allow informal comment and discussion of various practical issues arising from these proposed regulations.

If the final regulations do include automatic suspension for those charities whose tax exemption has been automatically revoked by the IRS or FTB, those regulations should include transition rules or a grace period to handle the huge inventory of tens of thousands of such charities.

Thank you for your consideration of these comments. If you have any questions on these points, please do not hesitate to contact me.

Sincerely,

Michael Folz Wexler

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