

**DESCRIPTION OF H.R. 1295,
A BILL TO IMPROVE THE PROCESS FOR MAKING
DETERMINATIONS WITH RESPECT TO WHETHER ORGANIZATIONS
ARE EXEMPT FROM TAXATION UNDER SECTION 501(c)(4)**

Scheduled for Markup
by the
HOUSE COMMITTEE ON WAYS AND MEANS
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Prepared by the Staff
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INTRODUCTION

The House Committee on Ways and Means has scheduled a committee markup of H.R. 1295, a bill to improve the process for making determinations with respect to whether organizations are exempt from taxation under section 501(c)(4), on March 25, 2015. This document,¹ prepared by the staff of the Joint Committee on Taxation, provides a description of the bill.

¹ This document may be cited as follows: Joint Committee on Taxation, *Description of H.R. 1295, a Bill to Improve the Process for Making Determinations With Respect to Whether Organizations Are Exempt From Taxation Under Section 501(c)(4)* (JCX-61-15), March 24, 2015. This document can also be found on the Joint Committee on Taxation website at www.jct.gov.

A. Require Section 501(c)(4) Organizations to Provide Notice of Formation

Present Law

Section 501(c)(4) organizations

Section 501(c)(4) provides tax exemption for civic leagues or organizations not organized for profit but operated exclusively for the promotion of social welfare, or certain local associations of employees, provided that no part of the net earnings of the entity inures to the benefit of any private shareholder or individual. An organization is operated exclusively for the promotion of social welfare if it is engaged primarily in promoting in some way the common good and general welfare of the people of a community.² The promotion of social welfare does not include direct or indirect participation or intervention in political campaigns on behalf of or in opposition to any candidate for public office; however, social welfare organizations are permitted to engage in political activity so long as the organization remains engaged primarily in activities that promote social welfare. The lobbying activities of a social welfare organization generally are not limited. An organization is not operated primarily for the promotion of social welfare if its primary activity is operating a social club for the benefit, pleasure, or recreation of its members, or is carrying on a business with the general public in a manner similar to organizations that are operated for profit.

Application for tax exemption

Section 501(c)(3) organizations

Section 501(c)(3) organizations (with certain exceptions) are required to seek formal recognition of tax-exempt status by filing an application with the IRS (Form 1023).³ In response to the application, the IRS issues a determination letter or ruling either recognizing the applicant as tax-exempt or not. Certain organizations are not required to apply for recognition of tax-exempt status in order to qualify as tax-exempt under section 501(c)(3) but may do so. These organizations include churches, certain church-related organizations, organizations (other than private foundations) the gross receipts of which in each taxable year are normally not more than \$5,000, and organizations (other than private foundations) subordinate to another tax-exempt organization that are covered by a group exemption letter.

A favorable determination by the IRS on an application for recognition of tax-exempt status will be retroactive to the date that the section 501(c)(3) organization was created if it files a completed Form 1023 within 15 months of the end of the month in which it was formed.⁴ If

² Treas. Reg. sec. 1.501(c)(4)-1(a)(2).

³ See sec. 508(a). Unless otherwise stated all section references are to the Internal Revenue Service Code of 1986, as amended (the “Code”).

⁴ Pursuant to Treas. Reg. sec. 301.9100-2(a)(2)(iv), organizations are allowed an automatic 12-month extension as long as the application for recognition of tax exemption is filed within the extended, *i.e.*, 27-month,

the organization does not file Form 1023 or files a late application, it will not be treated as tax-exempt under section 501(c)(3) for any period prior to the filing of an application for recognition of tax exemption.⁵ Contributions to section 501(c)(3) organizations that are subject to the requirement that the organization apply for recognition of tax-exempt status generally are not deductible from income, gift, or estate tax until the organization receives a determination letter from the IRS.⁶

Information required on Form 1023 includes, but is not limited to: (1) a detailed statement of actual and proposed activities; (2) compensation and financial information regarding officers, directors, trustees, employees, and independent contractors; (3) a statement of revenues and expenses for the current year and the three preceding years (or for the years of the organization's existence, if less than four years); (4) a balance sheet for the current year; (5) a description of anticipated receipts and contemplated expenditures; (6) a copy of the articles of incorporation, trust document, or other organizational or enabling document; (7) organization bylaws (if any); and (8) information about previously filed Federal income tax and exempt organization returns, if applicable.

A favorable determination letter issued by the IRS will state that the application for recognition of tax exemption and supporting documents establish that the organization submitting the application meets the requirements of section 501(c)(3) and will classify (as either an adverse or definitive ruling) the organization as either a public charity or a private foundation.

Organizations that are classified as public charities (or as private operating foundations) and not as private nonoperating foundations may cease to satisfy the conditions that entitled the organization to such status. The IRS makes an initial determination of public charity or private foundation status (either a definitive ruling, or an advance ruling generally effective for five years and then reviewed again by the IRS) that is subsequently monitored by the IRS through annual return filings. The IRS periodically announces in the Internal Revenue Bulletin a list of organizations that have failed to establish, or have been unable to maintain, their status as public charities or as private operating foundations, and that become private nonoperating foundations.

If the IRS denies an organization's application for recognition of exemption under section 501(c)(3), the organization may seek a declaratory judgment regarding its tax status.⁷ Prior to

period. The IRS also may grant an extension beyond the 27-month period if the organization is able to establish that it acted reasonably and in good faith and that granting relief will not prejudice the interests of the government. Treas. Reg. secs. 301.9100-1 and 301.9100-3.

⁵ Treas. Reg. sec. 1.508-1(a)(1).

⁶ Sec. 508(d)(2)(B). Contributions made prior to receipt of a favorable determination letter may be deductible prior to the organization's receipt of such favorable determination letter if the organization has timely filed its application to be recognized as tax-exempt. Treas. Reg. secs. 1.508-1(a) and 1.508-2(b)(1)(i)(b).

⁷ Sec. 7428.

utilizing the declaratory judgment procedure, the organization must have exhausted all administrative remedies available to it within the IRS.

Other section 501(c) organizations

Most section 501(c) organizations – including organizations described within sections 501(c)(4) (social welfare organizations, etc.), 501(c)(5) (labor organizations, etc.), or 501(c)(6) (business leagues, etc.) – are not required to provide notice to the Secretary that they are requesting recognition of exempt status. Rather, organizations are exempt under these provisions if they satisfy the requirements applicable to such organizations. However, in order to obtain certain benefits such as public recognition of tax-exempt status, exemption from certain State taxes, and nonprofit mailing privileges, such organizations voluntarily may request a formal recognition of exempt status by filing a Form 1024.

If such an organization voluntarily requests a determination letter by filing Form 1024 within 27 months of the end of the month in which it was formed, its determination of exempt status, once provided, generally will be effective as of the organization's date of formation.⁸ If, however, the organization files Form 1024 after the 27-month deadline has passed, its exempt status will be formally recognized only as of the date the organization filed Form 1024.

The declaratory judgment process available to organizations seeking exemption under section 501(c)(3) is not available to organizations seeking exemption under other subsections of the Code, including sections 501(c)(4), 501(c)(5), and 501(c)(6).

Revocation (and suspension) of exempt status

An organization that has received a favorable tax-exemption determination from the IRS generally may continue to rely on the determination as long as “there are no substantial changes in the organization's character, purposes, or methods of operation.”⁹ A ruling or determination letter concluding that an organization is exempt from tax may, however, be revoked or modified: (1) by notice from the IRS to the organization to which the ruling or determination letter was originally issued; (2) by enactment of legislation or ratification of a tax treaty; (3) by a decision of the United States Supreme Court; (4) by issuance of temporary or final Regulations by the Treasury Department; (5) by issuance of a revenue ruling, a revenue procedure, or other statement in the Internal Revenue Bulletin; or (6) automatically, in the event the organization fails to file a required annual return or notice for three consecutive years.¹⁰ A revocation or modification of a determination letter or ruling may be retroactive if, for example, there has been

⁸ Rev. Proc. 2013-9, 2013-2 I.R.B. 255. Prior to the issuance of Revenue Procedure 2013-9 in early 2013, an organization that filed an application for exemption on Form 2014 generally could obtain a determination that it was exempt as of its date of formation, regardless of when it filed Form 1024.

⁹ Treas. Reg. sec. 1.501(a)-1(a)(2).

¹⁰ Rev. Proc. 2013-9, 2013-2 I.R.B. 255.

a change in the applicable law, the organization omitted or misstated a material fact, or the organization has operated in a manner materially different from that originally represented.¹¹

The IRS generally issues a letter revoking recognition of an organization's tax-exempt status only after: (1) conducting an examination of the organization; (2) issuing a letter to the organization proposing revocation; and (3) allowing the organization to exhaust the administrative appeal rights that follow the issuance of the proposed revocation letter. In the case of a section 501(c)(3) organization, the revocation letter immediately is subject to judicial review under the declaratory judgment procedures of section 7428. To sustain a revocation of tax-exempt status under section 7428, the IRS must demonstrate that the organization no longer is entitled to exemption.

Upon revocation of tax-exemption or change in the classification of an organization (*e.g.*, from public charity to private foundation status), the IRS publishes an announcement of such revocation or change in the Internal Revenue Bulletin. Contributions made to organizations by donors who are unaware of the revocation or change in status ordinarily will be deductible if made on or before the date of publication of the announcement.

The IRS may suspend the tax-exempt status of an organization for any period during which an organization is designated or identified by U.S. authorities as a terrorist organization or supporter of terrorism.¹² Such an organization also is ineligible to apply for tax exemption. The period of suspension runs from the date the organization is first designated or identified to the date when all designations or identifications with respect to the organization have been rescinded pursuant to the law or Executive Order under which the designation or identification was made. During the period of suspension, no deduction is allowed for any contribution to a terrorist organization.

Description of Proposal

Under the proposal, an organization described in section 501(c)(4) must provide to the Secretary notice of its formation and intent to operate as such an organization, in such manner as the Secretary may prescribe. The notice, together with a reasonable user fee in an amount to be established by the Secretary, must be provided no later than 60 days following the organization's establishment and must include the following information: (1) the name, address, and taxpayer identification number of the organization; (2) the date on which, and the State under the laws of which, the organization was organized; and (3) a statement of the purpose of the organization. The Secretary may extend the 60-day deadline for reasonable cause. Within 60 days of receipt of a notice of an organization's formation and intent to operate as an organization described in section 501(c)(4), the Secretary shall issue to the organization an acknowledgment of the notice. The notice and receipt are subject to the disclosure requirements of section 6104.

¹¹ *Ibid.*

¹² Sec. 501(p) (enacted by Pub. L. No. 108-121, sec. 108(a), effective for designations made before, on, or after November 11, 2003).

The proposal amends section 6652(c) (which provides for penalties in the event of certain failures to file an exempt organization return or disclosure) to impose penalties for failure to file the notice required under the proposal. An organization that fails to file a notice within 60 days of its formation (or, if an extension is granted for reasonable cause, by the deadline established by the Secretary) is subject to a penalty equal to \$20 for each day during which the failure occurs, up to a maximum of \$5,000. In the event such a penalty is imposed, the Secretary may make a written demand on the organization specifying a date by which the notice must be provided. If any person fails to comply with such a demand on or before the date specified in the demand, a penalty of \$20 is imposed for each day the failure continues, up to a maximum of \$5,000.

With its first annual information return (Form 990, Form 990-EZ, or Form 990-N) filed after providing the notice described above, a section 501(c)(4) organization must provide such information as the Secretary may require, and in the form prescribed by the Secretary, to support its qualification as an organization described in section 501(c)(4). The Secretary is not required to issue a determination letter following the organization's filing of the expanded first annual information return.

A section 501(c)(4) organization that desires additional certainty regarding its qualification as an organization described in section 501(c)(4) may file a request for a determination, together with the required user fee, with the Secretary. Such a request is in addition to, not in lieu of, filing the required notice described above. It is intended that such a request for a determination be submitted on a new form (separate from Form 1024, which may continue to be used by certain other organizations) that clearly states that filing such a request is optional. The request for a determination is treated as an application subject to public inspection and disclosure under sections 6104(a) and (d).

Effective Date

The proposal generally is effective for organizations organized after the date of enactment.

Organizations organized on or before the date of enactment, that have not filed an application for exemption (Form 1024) or annual information return on or before the date of enactment must provide the notice required under the provision within 180 days of the date of enactment.

B. Declaratory Judgments for Section 501(c)(4) Organizations

Present Law

In order for an organization to be granted tax exemption as a charitable entity described in section 501(c)(3), it must file an application for recognition of exemption with the IRS and receive a favorable determination of its status.¹³ For most section 501(c)(3) organizations, eligibility to receive tax-deductible contributions similarly is dependent upon its receipt of a favorable determination from the IRS. In general, a section 501(c)(3) organization can rely on a determination letter or ruling from the IRS regarding its tax-exempt status, unless there is a material change in its character, purposes, or methods of operation. In cases where an organization violates one or more of the requirements for tax exemption under section 501(c)(3), the IRS generally may revoke an organization's tax exemption, notwithstanding an earlier favorable determination.

Present law authorizes an organization to seek a declaratory judgment regarding its tax-exempt status as a remedy if the IRS denies its application for recognition of exemption under section 501(c)(3), fails to act on such an application, or informs a section 501(c)(3) organization that it is considering revoking or adversely modifying its tax-exempt status.¹⁴ The right to seek a declaratory judgment arises in the case of a dispute involving a determination by the IRS with respect to: (1) the initial qualification or continuing qualification of an organization as a charitable organization for tax exemption purposes or for charitable contribution deduction purposes; (2) the initial classification or continuing classification of an organization as a private foundation; (3) the initial classification or continuing classification of an organization as a private operating foundation; or (4) the failure of the IRS to make a determination with respect to (1), (2), or (3).¹⁵ A "determination" in this context generally means a final decision by the IRS affecting the tax qualification of a charitable organization. Section 7428 vests jurisdiction over controversies involving such a determination in the U.S. District Court for the District of Columbia, the U.S. Court of Federal Claims, and the U.S. Tax Court.¹⁶

Prior to utilizing the declaratory judgment procedure, an organization must have exhausted all administrative remedies available to it within the IRS.¹⁷ For the first 270 days after a request for a determination is made and before the IRS informs the organization of its decision, an organization is deemed not to have exhausted its administrative remedies. If no determination is made during the 270-day period, the organization may initiate an action for declaratory

¹³ Sec. 508(a).

¹⁴ Sec. 7428.

¹⁵ Sec. 7428(a)(1).

¹⁶ Sec. 7428(a)(2).

¹⁷ Sec. 7428(b)(2).

judgment after the period has elapsed. If, however, the IRS makes an adverse determination during the 270-day period, an organization may immediately seek declaratory relief. The 270-day period does not begin with respect to applications for recognition of tax-exempt status until the date a substantially completed application is submitted.

Under present law, a non-charity (*i.e.*, an organization not described in section 501(c)(3)) may not seek a declaratory judgment with respect to an IRS determination regarding its tax-exempt status. In general, such an organization must petition the U.S. Tax Court for relief following the issuance of a notice of deficiency or pay any tax owed and file a refund action in Federal district court or the U.S. Court of Federal Claims.

Description of Proposal

The proposal extends the section 7428 declaratory judgment procedure to the initial determination or continuing classification of an organization as tax-exempt under section 501(a) as an organization described in section 501(c)(4) (*i.e.*, social welfare and certain other organizations).

Effective Date

The proposal is effective for pleadings filed after the date of enactment.

C. Estimated Revenue Effects

Fiscal Years [Millions of Dollars]												
<u>2015</u>	<u>2016</u>	<u>2017</u>	<u>2018</u>	<u>2019</u>	<u>2020</u>	<u>2021</u>	<u>2022</u>	<u>2023</u>	<u>2024</u>	<u>2025</u>	<u>2015-20</u>	<u>2015-25</u>
[1]	[1]	[1]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	1

NOTE: Details do not add to totals due to rounding.

[1] Estimate includes an increase in user fees of \$15 million and an increase in outlay of \$15 million from 2015-2025 (user fee and outlay estimate provided by the Congressional Budget Office).

[2] Loss of less than \$500,000.

[3] Gain of less than \$500,000.