

**DESCRIPTION OF H.R. 1314,
A BILL TO PROVIDE FOR A RIGHT TO AN ADMINISTRATIVE
APPEAL RELATING TO ADVERSE DETERMINATIONS OF
TAX-EXEMPT STATUS OF CERTAIN ORGANIZATIONS**

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INTRODUCTION

The House Committee on Ways and Means has scheduled a committee markup of H.R. 1314, a bill to provide for a right to an administrative appeal relating to adverse determinations of tax-exempt status of certain organizations, 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. 1314, a Bill to Provide for a Right to an Administrative Appeal Relating to Adverse Determinations of Tax-Exempt Status of Certain Organizations* (JCX-59-15), March 24, 2015. This document can also be found on the Joint Committee on Taxation website at www.jct.gov.

A. Require the Secretary of the Treasury to Describe Administrative Appeals Procedures Relating to Adverse Determinations of Tax-Exempt Status of Certain Organizations

Present Law

Section 501(c) organizations

Section 501(c) describes certain organizations that are exempt from Federal income tax under section 501(a). Section 501(c) organizations include, among others, charitable organizations (501(c)(3)), social welfare organizations (501(c)(4)),² labor organizations (501(c)(5)), and trade associations and business leagues (501(c)(6)). In addition to being exempt from Federal income tax, section 501(c)(3) organizations generally are eligible to receive tax deductible contributions. Section 501(c)(3) organizations are subject to operational rules and restrictions that do not apply to many other types of tax-exempt organizations.

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 Internal Revenue Service ("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

² 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, and no part of the net earnings of which 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. Treas. Reg. sec. 1.501(c)(4)-1(a)(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.

³ See sec. 508(a).

a completed Form 1023 within 15 months of the end of the month in which it was formed.⁴ If 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.

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, 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).

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 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 is not a "material change, inconsistent with exemption, in the character, the purpose, or the method of operation of the organization, or a change in the applicable law."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

⁷ Sec. 7428.

⁸ Rev. Proc. 2015-9, sec. 11, 2015-2 I.R.B. 249.

⁹ *Ibid.*

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 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.

Appeals of adverse determinations or revocations of exempt status

Adverse determination

If the IRS reaches the conclusion that an organization does not qualify for exempt status, the exempt organizations Rulings and Agreements unit ("EO Rulings and Agreements") or the exempt organizations technical unit located in Washington, D.C. ("EO Technical") will issue a proposed adverse determination letter or ruling. In either case, the proposed adverse

¹⁰ *Ibid.*, sec. 12.

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).

determination will advise the taxpayer of its opportunity to appeal the determination by requesting Appeals Office consideration.¹³

If an organization protests an adverse determination, EO Rulings and Agreements (if it maintains its adverse position) will forward the protest and the application case file to the Appeals Office, which will consider the organization's appeal. If the Appeals Office agrees with EO Rulings and Agreements, it will issue a final adverse determination letter or, if a conference was requested, schedule a conference with the organization. At the end of the conference process, the Appeals Office will issue a final adverse determination letter or a favorable determination letter.¹⁴

Under interim guidance issued on May 19, 2014, by the Acting Director, Rulings and Agreements (Exempt Organizations), an organization that receives a proposed adverse determination with regard to an application that has been transferred to EO Technical (or its successor) may request a conference with EO Technical in addition to requesting Appeals Office Consideration.¹⁵ Prior to that time, however, a determination letter issued on the basis of technical advice from EO Technical could not be appealed to the Appeals Office on issues that were the subject of the technical advice.¹⁶ The procedure described in the interim guidance has since been added to the IRS Revenue Procedure relating to exempt status determinations.¹⁷

Revocation or modification of a determination

As stated above, a determination letter or ruling recognizing exemption may be revoked or modified. In the case of a revocation or modification of a determination letter or ruling, the appeal and conference procedures are essentially the same as described above in connection with initial determinations of exempt status.¹⁸

Description of Proposal

The proposal effectively codifies the May 19, 2014, interim guidance by requiring the Secretary to describe procedures under which a section 501(c) organization may request an administrative appeal (including a conference relating to such an appeal, if requested) to the

¹³ Rev. Proc. 2015-9, 2015-2 I.R.B. 249, secs. 5 and 7.

¹⁴ *Ibid.*, sec. 7.

¹⁵ IRS Memorandum, "Appeals Office Consideration of All Proposed Adverse Rulings Relating to Tax-Exempt Status from EO Technical by Request," May 19, 2014.

¹⁶ Rev. Proc. 2014-9, 2014-2 I.R.B. 281, sec. 7.

¹⁷ Rev. Proc. 2015-9, 2015-2 I.R.B. 249, secs. 5 and 7.

¹⁸ *Ibid.*, sec. 12.

Internal Office of Appeals of an adverse determination. For this purpose, an adverse determination includes a determination adverse to the organization relating to:

1. the initial qualification or continuing classification of the organization as exempt from tax under section 501(a);
2. the initial qualification or continuing classification of the organization as an organization described in section 170(c)(2) (generally describing certain corporations, trusts, community chests, funds, and foundations that are eligible recipients of tax deductible contributions);
3. the initial or continuing classification of the organization as a private foundation under section 509(a); or
4. the initial or continuing classification of the organization as a private operating foundation under section 4942(j)(3).

Effective Date

The proposal is effective for determinations made after May 19, 2014.

B. Estimated Revenue Effects

The proposal is estimated to have a negligible effect on Federal fiscal year budget receipts for the period 2015-2025.