K. VOLUNTARY RELINQUISHING OF TAX EXEMPT STATUS

1. Introduction

Not all organizations that have been recognized as exempt under IRC 501(a) remain content with their status. Some organizations wish to relinquish exempt status simply because they find tax exemption unnecessary or the reporting requirements burdensome; others wish to convert to for-profit operations. The purpose of this topic is to discuss the technical and procedural issues presented when an organization attempts to relinquish its exempt status.

2. Attempts to Relinquish Exempt Status Where No Change in Operations Is Involved

a. General Principles

(1) Organizations That Are Not Private Foundations /*/ Cannot Voluntarily Relinquish Their Exempt Status

/*/ For a discussion of the special rules that apply to private foundations, see 2d below.

Neither the Internal Revenue Code nor the Regulations make provision for voluntary relinquishment of exempt status by organizations that are not private foundations. The language of IRC 501(a) merely states that an organization "described in subsection (c) ... shall be exempt from taxation under this subtitle." The use of the mandatory "shall" in IRC 501(a) has been construed by Chief Counsel to mean that so long as an organization does not violate the requirements of exemption neither the organization nor the Service may disregard such status. An organization's change of mind regarding its desire to be exempt is insufficient to overcome the mandatory language of IRC 501(a); only a change in operation or a proposed change in operation, e.g., an organization amends its charter to provide for payment of dividends, can terminate its exempt status.

The filing requirements imposed by IRC 6033 also militate against the Service allowing an organization to relinquish its exempt status. Organizations exempt under IRC 501(a) are required by IRC 6033(a)(1) to file an annual information return (unless excepted by IRC 6033(a)(2)). IRC 6104(b) provides that information gathered pursuant to IRC 6033 shall be made available to the public.

Therefore, allowing an organization that is not a private foundation to avoid the information return requirement by voluntarily relinquishing tax exempt status would constitute an abdication of the Service's responsibility to the public under IRC 6104(b). The Service cannot discharge or avoid this responsibility by acquiescing in an organization's "voluntary relinquishment" of its exempt status.

(2) An Organization May Not "De Facto" Relinquish Exempt Status By Failing To File Returns Without Other, Adverse Consequences - Statutory Penalties For Failure To File Are Involved

Rev. Rul. 59-95, 1959-1 C.B. 627, provides that failure or inability to file a required information return may result in the termination of the exempt status of an organization previously held exempt on the grounds that the organization has not established that it is observing the conditions required for continued recognition of exempt status. May not an organization, therefore, accomplish indirectly what it cannot do directly - i.e., instead of requesting termination of exempt status, may it not simply "fail" to file information returns, with the result that the IRS will terminate its exempt status for failure to file?

As a practical matter, that may indeed be the final outcome, but other things will happen first that the organization would likely consider untoward. Termination of exempt status is the ultimate course of action open to the Service. Termination is not, however, the first course of action to be considered; the first sanctions are contained in IRC 6652(d), which imposes the following penalties:

A. IRC 6652(d)(1) provides in part that failure to file a return required under IRC 6033 on the date and in the manner prescribed will result in a penalty of $ 10 for each day during which such failure continues, up to a maximum of $ 5,000, unless it is shown that such failure is due to reasonable cause.

B. IRC 6652(d)(2) provides for the additional penalty of $ 10 per day (up to a maximum of $ 5,000 per return) on any exempt organization officer, director, trustee, employee, member or other individual who is under a duty to file the return and who fails to file without reasonable cause after receiving written demand from the

IRS. Joint and several liability is imposed where more than one person is responsible for the failure to file.

IRC 6652(d) was enacted pursuant to the Tax Reform Act of 1969. The legislative history indicates Congress was concerned that there were no sanctions for failure to file information returns other than the criminal penalties of IRC 7203 and the revocation process outlined in Rev. Rul. 59-95. Congress concluded that a more "appropriate course" would be to follow the precedents of the penalties already established in the IRC as to dividends, interest, and withholding tax information returns. (See H.R. Rep. No. 91-43 (Part 1) Cong., 1st Sess. 37 (1969), 1969-3 C.B. 200, 224.) Moreover, during consideration of the Tax Reform Act of 1969, the Treasury Department represented to Congress that the $10 a day penalty was the appropriate way to secure timely and complete information returns. Accordingly, the IRC 6652(d) penalties are the first sanctions to apply when an organization fails, without reasonable cause, to file a required information return.

IRM 7(10)63.7 sets forth procedures to be followed when an organization refuses to file a required information return. IRM 7(10)63.10 establishes criteria to determine "reasonable cause" for not filing. In addition, 910-923 of IRM 7820 provides delinquency check procedures. An outline of the procedures concerning non-filers is set forth below.

If an exempt organization does not file a return, the appropriate key district ascertains the correct filing liability of the organization, informs the organization in writing, and solicits the required return, if due. If the organization is liable for a return but fails to respond, the procedures outlined in IRM 7(10)63.7 should be followed.

IRM 7(10)63.72 notes the holding of Rev. Rul. 59-95 (failure to file an information return can result in termination of exempt status). However, it states that revocation is appropriate only in the exceptional case where the sanctions of IRC 6652 have proved ineffective in securing compliance with the filing requirements of IRC 6033.

Therefore, if an organization is required, but refuses, to file an annual information return, IRM 7(10)63.72 provides that a written demand by certified mail will be sent to the organization requesting that the return be filed with the key district within 90 days of the written demand. The written demand will inform the organization of the $10 per day penalty imposed by IRC 6652(d)(1) and solicit an

explanation of reasonable cause for not filing. (The procedures further state that the written demand also will contain notice of potential revocation of exempt status.)

If the organization provides the return or documents acceptable reasonable cause for not doing so, the penalty will not be assessed. If the organization does not respond, the $10 per day penalty will be assessed and a bill sent. (The Service is not precluded from assessing the IRC 6652(d) penalty prior to reaching the maximum $5,000 penalty.)

Although not mentioned in IRM 7(10)63.7, the application of IRC 6652(d)(2) penalty against the person or persons under a duty to file the exempt organization's information return should be considered. This will require the issuance of a written demand notice from the Service to the responsible person or persons. This sanction should help achieve a greater rate of compliance and may be effective in some situations where the IRC 6651(d)(1) penalty is uncollectible. For example, a foreign organization has secured exempt status to avoid taxation of its United States investment income. It disposes of this income, and, finding exempt status not currently advantageous, stops filing information returns, although still required to do so. The threat of assessment of the IRC 6652(d)(1) penalty may not be effective because there is no United States income to assess. However, as any person under a duty to file a particular exempt organization's return may be liable for the IRC 6652(d)(2) penalty, this sanction may prove an effective deterrent, since one or more of the persons under a duty to file might have assets in the United States.

Another procedure, short of revocation, which is applicable to certain exempt organizations that are required to, but do not, file annual information returns, is deletion of such organizations from Publication No. 78, "Cumulative List of Organizations described in Section 170(c) of the Internal Revenue Code of 1954." The introduction to Publication No. 78 provides:

> Publication No. 78 is updated and reissued annually. Additions are published in cumulative quarterly supplements. The supplements do not list deletions and changes of status, however when the Internal Revenue Service withdraws recognition of status or when an organization's status changes an announcement is made in the Internal Revenue Bulletin.
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> Organizations which are required to file annual information returns on either Form 990 (Return of Organization Exempt from Income Tax)

> or Form 990-PF (Return for Private Foundation Exempt From Income Tax) as required by section 6033 of the Code, but which have not done so for two years (extensions of time to file considered) prior to the extension date of this edition, may not be included in this listing. However, the exclusion of an organization from the Cumulative List because of this does not constitute the termination of the Internal Revenue Service's recognition of exempt status.

Procedures for processing entries in Publication No. 78 are set forth in Chapter (13) of IRM 7820. These procedures provide that organizations excepted from filing annual information returns by IRC 6033(a)(2)(B) (principally, churches, certain church affiliated organizations, and organizations that have established their gross receipts are normally $25,000 or less), are coded on the Exempt Organizations/Business Master File (EO/BMF) as not being liable for filing annual information returns and are not affected by the Service's return posting check procedures. These organizations are included in Publication No. 78 without regard to whether a return is filed ((13)21(3) of IRM 7820). However, other organizations, which are coded as being liable for returns, are sent a Form 990 package, which gives them the option of establishing that they are not required to file by checking the box indicating that their gross receipts are normally $25,000 or less. If a delinquency notice is sent, and the organization responds by indicating that its gross receipts normally are not greater than $25,000, the organization's filing requirement is "turned off" (the organization's Form 990 filing requirement code on the Business Master File is changed to one indicating that the organization's gross receipts normally are below the threshold amount) and the organization would be included in subsequent editions of Publication No. 78. If the organization fails to indicate that a return need not be filed, the organization would not be selected for inclusion in Publication No. 78 if no return was filed for two years prior to the extraction of a particular edition ((13)21(2) of IRM 7820).

It should be noted that since the extraction procedure does not require that the organization's exempt status be reviewed, and since the exclusion of an organization from the Cumulative List as a result of this procedure does not constitute termination of the Service's recognition of exempt status, the omission of an organization from Publication No. 78 does not give rise to a declaratory judgment right under IRC 7428.

The final sanction is revocation. As explained in the 1984 CPE topic, "Incomplete Returns Program" (p. 149 of the text), revocation of an organization's exempt status is appropriate in the exceptional case where the following

circumstances exist: (a) the sanctions of IRC 6652(d)(1) and (2) have proved to be ineffective in securing compliance with IRC 6033, and (b) the organization's continued entitlement to exempt status is in doubt. The effective date of revocation, when the sanction is applicable, would be subsequent to the imposition of the IRC 6652(d) penalties. (Revocation for a prior period would preclude assessment of such penalties inasmuch as IRC 6652(d) applies only to exempt organizations.) As stated on page 158 of the 1984 CPE text, the key to revocation is determining that the organization's continued entitlement to exempt status is substantially in doubt. Based upon the facts and circumstances in each case, the key district must make this determination. The basis for any revocation in such cases is that the organization has failed to provide information considered by the IRS to be material to a determination of continued recognition of its present status. Any proposed revocation must indicate the specific information not provided, described its relevance to exempt status, and provide clear support for the conclusion that failure to provide the information logically leads to a question whether the organization is entitled to retain exemption.

Therefore, for example, should the previously discussed foreign organization fail to pay the IRC 6652(d)(1) penalty, and should the key district determine its entitlement to exempt status is substantially in doubt, a proposed revocation letter would be issued. Should the organization subsequently have United States investments, it would have to reapply for exempt status, and the IRC 6652(d)(1) penalty previously assessed would be collectible. (While IRC 6501(a) provides time limitations for the assessment and collection of tax, IRC 6501(c)(3) provides that, in the case of failure to file a return, the tax may be assessed, or a proceeding in court for the collection of such tax may begin without assessment, at any time.)

In summary, the Service's procedures with respect to exempt organizations that fail, without reasonable cause, to file annual information returns, are directed towards enhancing compliance with IRC 6033. Therefore, once it has been established that an organization is required to file and has failed to do so without reasonable cause, the actions of the Service first involve the imposition of IRC 6652 sanctions and, where appropriate, omission of the organization from Publication No. 78. Revocation of a non-filing organization's exempt status may be necessary, but it is an action to be taken only after other areas have been exhausted.

b. Brief Notes on Organizations That Dissolve, Or Become Inactive (IRM 7666(15))

(1) Dissolved Organizations

If an exempt organization has been dissolved, the key District Director should obtain any required final returns, such as Form 990, copies of any documents authorizing the dissolution, and a statement signed by an officer of the organization showing the disposition of any assets on hand at the date of dissolution. Upon receipt of these documents, the key District Director may issue a letter terminating the organization's exemption letter as of the date of dissolution. In cases involving IRC 170, the termination letter will contain a statement terminating the deductibility of contributions.

In cases where an organization that had been recognized as exempt has been dissolved and the key District Director is unable to locate its former officers, a termination letter need not be issued. However, the key District Director's records should be so noted.

(2) Inactive Organizations

Where an organization recognized as exempt becomes inactive for a period of time but retains identity as a corporation or association, its exemption letter need not be revoked. However, if the evidence (assuming any exists) clearly indicates that the organization never will resume operating for an exempt purpose, as required by Reg. 1.501(c)(3)-1(c)(1), its exempt status should be revoked pursuant to Rev. Proc. 84-46, 1984-1 C.B. 541. Inactive organizations that are not revoked are required to continue filing information returns if filing is a requirement (see 2 a(2), above) of their exemption.

c. Private Foundations That Voluntarily Terminate

(1) Introduction

As previously noted, private foundations constitute the single exception to the general rule that exempt organizations may not voluntarily relinquish their exempt status. (This is because, in enacting the Tax Reform Act of 1969, Congress wished to encourage the shift of charitable holdings from the hands of private foundations to immediate charitable use and thus provided in IRC 507 several methods by which this might be accomplished.)

IRC 507 provides that a private foundation within the meaning of IRC 509(a) may not voluntarily terminate its private foundation status unless it notifies the Service of its intent to terminate and pays, or has abated, a termination tax (IRC

507(a)(1)); distributes all of its assets to certain qualifying pre-existing public charities (IRC 507(b)(1)(A)); or itself operates as a public charity (IRC 507(b)(1)(B)).

"Termination" is a statutorily created word of art that refers only to an organization's legal status as a private foundation, and has nothing to do with an organization's possession or non-possession of assets. "Termination" requires strict compliance with one of the methods set forth in IRC 507. Therefore, a private foundation's disposition of all of its assets will have no effect on its private foundation status unless one of the particular provisions of IRC 507 are applicable.

Because IRC 507 provides exclusive methods of termination, private foundations already recognized as exempt under IRC 501(c)(3) cannot avoid classification as a private foundation by obtaining reclassification under another IRC subsection, e.g., IRC 501(c)(4). IRC 509(b) provides that if an organization is a private foundation on October 9, 1969, or becomes a private foundation on any subsequent date, such organization shall be treated as a private foundation for all periods after October 9, 1969, or after such subsequent date, unless its status as a private foundation is terminated under IRC 507. Reg. 1.509(a)(1) provides the following example:

> ...[I]f on October 9, 1969, an organization was described in section 501(c)(3), but because of its activities, it could also have qualified as an organization described in IRC 501(c)(4), such organization will continue to be treated as a private foundation, if it was a private foundation within the meaning of IRC 509(a) on October 9, 1969.

This section of the topic will focus on the termination procedures of IRC 507(a)(1) and (b)(1)(B), since termination under those subsections also involves relinquishment of exempt status. It will also discuss transfers that do not result in termination, and the tax consequences of such transfers.

(2) <u>Termination Under IRC 507(a)(1)</u>

Termination under IRC 507(a)(1) is available only to private foundations that are not guilty of any repeated or flagrant violations of Chapter 42 provisions that give rise to tax liability. In order to terminate under IRC 507(a)(1), the following conditions must be met:

(a) Notification is required. Therefore, the organization must submit to the appropriate District Director a statement that it intends to terminate its private foundation status under IRC 507(a)(1).

(b) There is a tax imposed by IRC 507(c) on organizations that terminate under IRC 507(a)(1). Therefore, the statement to the District Director must set forth in detail the computation and amount of tax. Unless the organization requests abatement of the tax under IRC 507(g), full payment of the IRC 507(c) tax must be made at the time the statement is filed. (Reg. 1.507-1(a)(b)(1)).

IRC 509(c) provides that an organization that terminates its status under IRC 507 shall be treated as an organization created on the day after the date of such termination. Therefore, Regs. 1.509(c)-1(a) and 1.507-1(b)(3) provide that an organization whose private foundation status has been terminated under IRC 507(a), will, if it continues to operate, be treated as a new organization and must, if it desires to be recognized as exempt under IRC 501(c)(3), give notice that it is applying for recognition of IRC 501(c)(3) status (unless it is excepted from the notice requirement under IRC 508(c)).

A voluntary termination under IRC 507(a)(1) does not relieve a private foundation, or any disqualified person, of Chapter 42 tax liability for acts, or failures to act, that occurred before termination. Furthermore, such a termination does not forgive any additional taxes imposed for any failure to correct a Chapter 42 violation (Reg. 1.507-1(b)(2)).

(3) <u>Termination Under IRC 507(b)(1)(A)</u>

A private foundation may voluntarily terminate its private foundation status under IRC 507(b)(1)(A) by distributing all its net assets to one or more public charities that are described in IRC 170(b)(1)(A)(i)-(vi) and have been public charities for 60 continuous months before the distribution of the private foundation's assets. Like organizations that terminate under IRC 507(a)(1), an organization terminating under IRC 507(b)(1)(A) must not be guilty of any repeated or flagrant violations of exempt status. Furthermore, similar to IRC 507(a)(1) termination, an organization terminating under IRC 507(b)(1)(A) also relinquishes its exempt status. If such an organization remains in existence after termination, it must file (unless excepted by IRC 508(c)) an application for

recognition of exemption to be treated as an organization described in IRC 501(c)(3) (Rev. Rul. 74-490, 1974-2 C.B. 171).

Unlike private foundations that terminate under IRC 507(a)(1), a private foundation that terminates under IRC 507(b)(1)(A) is not required to notify the Service and does not incur the IRC 507(c) termination tax (Reg. 1.507-2(a)(1)). However, an organization that terminates its private foundation status by transferring its assets to a qualified public charity remains subject to the private foundation rules until the required distribution of all its net assets has been completed (Reg. 1.507-2(a)(4)).

A private foundation meets the requirement that it "distribute all of its net assets" within the meaning of IRC 507(b)(1)(A) only if it transfers "all of its right, title, and interest in and to all of its net assets" to one or more qualified public charities (Reg. 1.507-2(a)(7)).

In order to effectuate a transfer of "all of its right, title, and interest in and to all of its net assets," a transferor foundation may not impose any material restrictions or conditions that prevent the transferee public charity from freely and effectively employing the transferred assets, or the income derived therefrom, in furtherance of its tax-exempt purposes. Whether or not a particular condition or restriction imposed upon a transfer of assets is "material" must be determined from all the facts and circumstances of the transfer. Some of the more significant facts and circumstances to be considered in making this determination are whether the public charity is the owner in fee of the assets it receives from the private foundation; whether the assets are held and administered by the public charity in a manner consistent with one or more of its exempt purposes; whether the governing body of the public charity has the ultimate authority and control over the assets, and the income derived therefrom; and whether, and to what extent, the governing body is organized and operated so as to be independent of the transferor (Reg. 1.507-2(a)(8)).

(4) Transfers That Do Not Result In Termination - IRC 507(b)(2)

As noted above, IRC 507(a)(1) and (b)(1)(A) are specific in their requirements, and unless a private foundation follows these requirements when it transfers its assets, voluntary termination is not accomplished. Therefore, if a private foundation transfers all its assets to one or more persons, but less than all of its net assets to one or more organizations that have been described in IRC 170(b)(1)(A)(i)-(vi) for a continuous period of 60 calendar months, the transferor

foundation will not have voluntarily terminated its status unless it has followed the IRC 507(a)(1) procedures, and the foundation will continue to be treated as a private foundation for all purposes. For example, if a private foundation transfers all its assets to an IRC 509(a)(2) organization and two years later receives a bequest, the bequest will be regarded as having been made to a private foundation, and the foundation will be subject to the provisions of Chapter 42 with respect to such funds. As a further example, if a private foundation makes a transfer of all its net assets to an IRC 509(a)(2) or (a)(3) organization, it must retain sufficient income or assets to pay the tax imposed on investment income (IRC 4940) for that portion of its taxable year prior to the transfer (Reg. 1.507-1(b)(7)).

A recent case illustrates that the IRC 507 termination requirements must be followed strictly and that significantly adverse tax consequences may result if they are not followed. In Gladney v. Commissioner, 745 F. 2d 955, [54 AFTR2d 84-6350] (5th Cir. 1984), a testator left property to establish a home for aged and infirm men. The trustees organized a charitable corporation known as the Board of Trustees of the John M. Bonner Memorial Home (the Board). The Board, which was recognized as exempt under IRC 501(c)(3) and classified as a private foundation under IRC 509(a), experienced financial difficulties, and, for the last 20 years of its existence, had to draw on its endowment to pay operating costs.

On July 1, 1971, the Board closed the home because the operating costs exceeded the revenues of the trust fund. On November 5, 1971, the heirs of the residuary legatees filed a petition in state court requesting that the Board be dissolved and that the heirs be declared entitled to the remaining assets. On December 23, 1971, the court dissolved the Board and ordered the assets distributed to the heirs. The Board did not appeal the decision and delivered the assets to the heirs in early 1972. On October 24, 1973, the Board notified the Service that it had been dissolved and that final distribution of assets had been made.

On March 21, 1977, the Service mailed notices to each of the heirs asserting excise tax liability under IRC 4945 due to their status as transferees of non-charitable expenditures by a private foundation.

The Tax Court, Gladney v. Commissioner, 45 T.C. Mem. 280 (1982), held that the Board's private foundation status was terminated upon the entry of the state court's judgment and that transfers of assets in accordance with that judgment did not give rise to tax liability. The Court also held that the IRC 501(c)(1) notification requirements were satisfied by the Board's filings after the distribution of the

assets, noting the following circumstances: (1) the home had been closed for six months prior to the judgment of the state court, (2) there was no IRC 507(c) tax liability at the time of the judgment, and (3) the Service had not issued regulations under IRC 507 at the time the distributions were made.

The Fifth Circuit reversed, holding that the trust had never terminated its private foundation status. The Trust's status as a private foundation was not terminated when the home closed since "termination" as used in IRC 507 is a statutory term of art that refers only to the organization's legal status, not to its operational status. Furthermore, after-the-fact notification to the IRS, such as given by the Board here, is not substantial compliance with the notification requirements of IRC 507. The court dismissed the remaining "facts and circumstances" analysis of the Tax Court. It found that the failure of the Service to promulgate regulations under IRC 507(a)(1) by the time the Board made the distribution did not relieve the Board of its duty to notify the Service of its termination in some manner. It further concluded that the fact that the Board had zero liability for the termination tax imposed by IRC 507(c) did not relieve the Board of its duty to notify the IRS of its termination as a private foundation, since the notification requirement of IRC 507 has legislative purposes other than just to permit the Service to compute the termination tax liability (e.g., providing the Service and, through the operation of IRC 6104, the states with information necessary to enforce federal tax law, state common law and state statutory requirements regarding exempt organizations). Therefore, since private foundation status had not been terminated when the Board distributed the assets to the heirs, the heirs, as transferees, were liable for the tax imposed on taxable expenditures by IRC 4945.

A question not posed in Gladney is whether a foundation could first notify the District Director of its intent to terminate and then -- when it purportedly was no longer a private foundation -- make a distribution of its assets to noncharitable entities. The position of the Service is that IRC 4945 liability would still be incurred. This position is supported by the doctrine that "the tax consequences of an interrelated series of transactions are not to be determined by viewing them in isolation but by considering them together as component parts of an overall plan." Crenshaw v. United States, 450 F. 2d 472, 475 (5th Cir. 1971). Therefore, where an organization intends to commit a violation of a Chapter 42 excise tax provision, any attempts it makes first should be considered part of the same overall plan as the act subject to Chapter 42, and should be held not to have been accomplished prior to the organization's commission of that act and, therefore, not shield the organization from Chapter 42 liability.

A related question, and one which is more commonly asked, is whether private foundations that are in the process of dissolving need to terminate their private foundation status as provided for under IRC 507. 741(4) of IRM 7752 states there is no such requirement - there is no provision in the statute that imposes IRC 507(c) tax on foundations that dispose of their assets by distributing their assets upon dissolution. Therefore, a private foundation may, for example, distribute all of its assets to an IRC 509(a)(2) organization without adverse tax consequence (Reg. 1.507-1(b)(7)). However, as Gladney demonstrates, liability under Chapter 42 arises if distributions are made in violation of that Chapter, and if the organization is no longer in existence, the transferees would be liable for the tax. (The subject of transferee liability will be discussed later in this topic.)

The final subject of this section is a specific provision under which termination does not occur - IRC 507(b)(2). IRC 507(b)(2) is applicable to transfers between private foundations, as where private foundations consolidate into one larger private foundation to save administrative costs, or where a small private foundation merges with a larger private foundation.

The types of transfers covered by IRC 507(b)(2) include: any liquidation, merger, redemption, recapitalization, partial liquidation, reorganization, adjustment, or other significant disposition of assets, other than transfers for full consideration or distributions out of current income. The purpose of IRC 507(b)(2) is to maintain the applicability of Chapter 42 to charitable assets that are transferred from one private foundation to another. Therefore, these transfers result in a carryover of certain tax attributes and characteristics of the transferor organization to the transferee.

3. Organizations That Convert to For-Profit Operations

Tax exempt status confers several obvious economic benefits on an organization. It saves it a portion of its net income which can be used for the exempt function. This saving may be especially substantial when the savings arising from exemptions granted by state and local governments as to income and *ad valorem* taxes are added to the savings on federal income tax. In addition, federal tax exempt status under IRC 501(c)(3) generally allows the organization to solicit tax deductible contributions and thereby substantially broaden its financial support. Peripheral benefits such as reduced postal rates may also flow.

On the other hand, if an organization is not generally sustained by contributors, it may find operation on a for-profit basis appealing. This is

especially the case in a situation where the income saved in federal, state, and local taxes, postal rates, etc., is outweighed by the disadvantages of tax exempt status, such as limitations on activities, requirement of operation for exempt purposes only, and, of course, prohibition of the distribution of earnings.

Conversion to for-profit status, however, presents formidable difficulties. For organizations incorporated under a state's nonprofit corporation statute, conversion would require reincorporation. For an organization exempt under IRC 501(c)(3), even if reincorporation is not necessary to convert to for-profit operations, the organization is subject to the state's powers to enforce the charitable purposes for which it is organized; moreover, the Internal Revenue Service insists on notification of such changes in operations, and the Internal Revenue Code requires permanent dedication of charitable assets to charitable use. (There are rare instances where a 501(c)(3) corporation reorganizes as a taxable corporation and the assets remain dedicated to exempt purposes, e.g., where the stock of the corporation is solely owned by a related IRC 501(c)(3) entity. (G.C.M. 36947, December 10, 1976; Letter Ruling 8444086).)

Therefore, an organization wishing to operate on a for-profit basis may adopt various subterfuges. It may set up a for-profit organization and transfer all its assets. It may amend its organizational document, distribute earnings to shareholders, and hope no one notices. This portion of the topic will discuss the enforcement powers that apply to situations where an organization has already converted to for-profit operations or has rendered itself insolvent by transferring its assets to a for-profit entity.

4. Coordination With State Officials

In 1975, Alvin D. Lurie, then Assistant Commissioner (Employee Plans and Exempt Organizations), spoke before the Special Committee on Charitable Trusts and Solicitations of the National Association of Attorneys General on the subject of regulation of charitable organizations.

Mr. Lurie stated that, basically, the only sanction provided by the IRC for a violation of IRC 501(c) is revocation of exempt status. (Under Chapter 42 of the IRC penalty taxes provide remedies other than revocation for specified violations; however, these provisions apply only to private foundations.) The Service makes determination of tax exempt status and monitors compliance with the exemption requirements. However, when a violation is discovered, the Service does not have any authorization to invoke the jurisdiction of an equity court with its broad and

adaptable powers to compel charitable use, invoke the cy pres doctrine, transfer assets, surcharge or dismiss trustees, etc.

Mr. Lurie further noted, however, with respect to organizations exempt under IRC 501(c)(3), the Service's oversight responsibility is shared with the states' attorneys general offices. While states are not concerned about the federal tax exemption of a charitable organization, per se, they are concerned that the organization faithfully conforms to the requirements of its privileged status as a charitable entity (Excerpts from talk printed in 43 Journal of Taxation 58, July, 1975.)

In order to facilitate effective enforcement of state common law and statutory requirements regarding charitable organizations, Congress enacted IRC 6104(c) as part of the Tax Reform Act of 1969. Under this section, the Service must notify the appropriate state official (tax officer, attorney general, or other official charged with overseeing charitable organizations) of the following information regarding any organization described in IRC 501(c)(3) and exempt under IRC 501(a):

(1) the refusal of the Service to recognize the organization's exemption;

(2) the organization's operation no longer meets the requirements of its exemption; or

(3) the mailing of a notice of deficiency in the payment of the tax on termination of private foundation status or any of the excise taxes imposed for private foundation violations.

In addition, the Service is required to make available for inspection by the state official any information about items (1) through (3) above, relevant to any determination under state law.

Therefore, under IRC 6104(c) the Service's obligation is to let the state know whenever an adverse action has been taken against a public charity's exempt status or exemption application (or whenever an excise tax or a penalty is imposed on a private foundation.) However, all the Service can do, after it has issued the final determination or notice of deficiency, unless the state acts, is to proceed with tax

collection. In revocation cases, therefore, the basic purpose of the notice to the state under IRC 6104(c) is to set into motion state equity powers.

5. Collection - IRC 6901

Attempts to prevent by law the relinquishment of exemption are a little like attempts to outlaw suicide - the law is broken only if the suicide is successful, in which case there is no way to enforce the law against the deceased perpetrator of the violation. It is in part because of that "Catch 22" that the imposition of transferee liability becomes necessary to prevent abuses, at least insofar as the federal government's interests are concerned.

A corporation whose tax exempt status is revoked will pay tax on its net income at corporate rates from the effective date of revocation. If the revoked organization is a trust, its remaining net income, after deduction of expenses for administration, etc. would be subject to individual rates from the effective date of revocation.

It may happen, however, that the revoked organization does not have sufficient assets on hand to meet the projected liability. This may be because the organization has become insolvent, or has ceased to exist. The following circumstances, extracted from H. Rept. 356, 69th Cong., 1st sess. (1926), p. 43, which explains the predecessor of IRC 6901, are illustrative:

> (1) Corporation A may distribute its assets to its shareholders and thereupon either dissolve or continue undissolved.
>
> (2) Corporation A may sell its assets to corporation B for a fair consideration either in cash or property or in stock of B. The proceeds are transmitted by corporation B to the shareholders of corporation A or indirectly to them through corporation A. Corporation A thereupon either dissolves or continues undissolved....
>
> (3) Corporation A may reorganize into a partnership.
>
> (4) Corporation A may reorganize into corporation B ... by an amendment of the financial provisions of its charter....

Because Congress saw that these and other situations might occur, the predecessor to IRC 6901 was enacted. IRC 6901 provides a procedure, or more properly, a complex set of rules under which the Service may proceed against a transferee of property with respect to the assessment and collection of income taxes owed by the transferor. The liability of the transferee may be established either at law (e.g., transferee, in connection with transfer of assets, agrees to pay the obligations of the transferor, expressly or by implication), or in equity (e.g., a transfer of assets is made without adequate consideration and leaves the taxpayer insolvent). The existence and extent of a transferee's liability at law or in equity is determined by applicable state law. Commissioner v. Jean F. Stern, 357 U.S. 39 (1958), 1958-2 C.B. 937. In general, however, the Commissioner makes out a prima facie case of transferee liability in equity by proving (1) that there has been no consideration or an inadequate consideration; (2) that this transfer of assets left the transferor insolvent (or was made to defraud creditors); (3) the value of the assets transfered, and (4) that the transferor has been proceeded against or that effort to collect would be a useless gesture (9 Mertens, Law of Federal Income Taxation Section 53.45).

The proceeding against the transferee must have been begun during the applicable period specified in the statute of limitations provided in IRC 6901.

As a practical matter, the provision in IRC 6901(c)(1) gives the Commissioner at least 4 years in which to make an assessment against an initial transferee.

In the case of a transferee of a transferee (see IRC 6901(c)(2)), the period of limitations for assessment is the lesser of: (1) the period against the preceding transferee (4 years) plus 1 year; or (2) 3 years after the period against the transferor ends. (Therefore, the Commissioner will always be allowed 5 years, but never more than 6 years.)

There are certain exceptions to the above rules but no attempt will be made to cover those here.

At times, it may be to the advantage of both the transferee and the government to extend the period of limitations for assessment against the transferee in order that an accurate determination of the transferee liability can be made. Therefore, IRC 6901(d)(1) authorizes the transferee and the government to enter into an agreement extending the statutory period.

The above discussion should be considered as no more than an overview of IRC 6901. Its purpose, rather, is to demonstrate that procedures are available in cases where formerly exempt organizations seek to frustrate collection of tax by dissolving or transferring their assets.