L. REVIEW OF CURRENT ISSUES UNDER IRC 508

1. Introduction

This article provides a summary of current developments under IRC 508 and is intended to supplement previous EOATRI articles issued on this subject. A major portion of this topic is concerned with various aspects of IRC 508 notification requirements, however, other issues that have arisen with respect to IRC 508 generally are also discussed. Notification requirements regarding private foundation status are not covered in this topic.

2. The 15-Month Rule

IRC 508(a) provides generally that an organization organized after October 9, 1969, will not be treated as described in IRC 501(c)(3) unless it gives notice to the Service in an appropriate manner. Reg. 1.508-1(a)(2)(i) provides, in part, that this notification requirement is satisfied when an organization seeking exemption under IRC 501(c)(3) files a properly completed and executed Form 1023 within 15 months from the end of the month in which it was organized. Reg. 1.508(a)-1(a)(2)(iii) provides further that an organization will be considered "organized" on the date it becomes an organization described in section 501(c)(3).

The notification requirement set forth in IRC 508(a) is subject to exceptions and these are listed in IRC 508(c). There is a mandatory exception to notice which is applicable to (1) churches, their integrated auxiliaries, and conventions or associations of churches or (2) any organization, other than a private foundation, the gross receipts of which in each taxable year are normally not more than $5,000. The exceptions in IRC 508(c) are interpreted and explained by Reg. 1.508-1(a)(3). With this background presented, this topic will explore several issues that have been considered in connection with IRC 508 notice requirements.

3. When Does the 15-Month Period Begin to Run?

A number of questions have arisen with respect to the date on which one begins to compute the 15-month period in order to determine whether IRC 508(a) notice requirements have been satisfied. These questions have been raised in regard to trusts described in IRC 4947(a)(1) and the first date on which a nonprofit corporation is considered "organized" for purposes of IRC 508(a).

a. IRC 4947(a)(1) Trusts

Although IRC 508(a) does not apply to a trust described in IRC 4947(a)(1), it can have the effect of preventing such a trust from obtaining exemption under IRC 501(c)(3) for the period prior to its submission of an application for recognition of exemption. Where a trust submits an application for exemption beyond the 15-month deadline, it will be treated as an organization described in IRC 501(c)(3) for the period after the date of its IRC 508(a) notice and as a trust described in IRC 4947(a)(1) for the period prior to submission of the notice. This can result in a number of differences in its tax treatment. For example, if it is a private foundation it will be taxed under IRC 4947(b) for the period prior to its IRC 508(a) notice and under IRC 4940(a) for the period after the submission of its notice.

One question that has been raised in regard to IRC 4947(a)(1) trusts and IRC 508 notice requirements relates to the determination of the date of creation of such trusts. The answer to this question requires reference to the regulations under IRC 4947(a)(1).

Reg. 53.4947-1(b)(1)(i) provides that, for purposes of satisfying the organizational test set forth in Reg. 1.501 (c)(3)-1(b) when a charitable trust seeks an exemption from taxation under IRC 501(a) a charitable trust shall be considered organized on the day it first becomes subject to IRC 4947(a)(1).

Reg. 53.4947-1(b)(2)(i) generally provides that a charitable trust created by a will shall be considered a charitable trust under IRC 4947(a)(1) as of the date of death of the decedent-grantor. Thus, where a charitable trust created by will has applied for recognition of exemption under IRC 501(c)(3), the date of death of the decedent-grantor is the starting point for purposes of determining whether the 15-month period under IRC 508(a) and the regulations thereunder has been satisfied.

This general rule, however, is subject to the narrow exception in Reg. 53.4947-1(b)(2)(v), which provides that a revocable trust that becomes irrevocable upon the death of the decedent-grantor, or a trust created by will, from which the trustee is required to distribute all of the net assets in trust for or free of trust to charitable beneficiaries is not considered a charitable trust under IRC 4947(a)(1) for a reasonable period of settlement after becoming irrevocable. After this period, the trust is considered a charitable trust described in IRC 4947(a)(1).

An inter vivos trust (established during the life of the creator) is considered organized as an IRC 4947(a)(1) trust on the first day it has amounts in trust for which a deduction was allowed under IRC 170, 545(b)(2), 642(c), 2055, 2106(a)(2) or 2522. Thus, the determination of the effective date of creation of an inter vivos trust necessarily requires reference to the event that forms the basis for allowance of the deduction under one of the foregoing provisions.

b. Nonprofit Corporations

Rev. Rul. 75-290, 1975-2 C.B. 215, provides that, in determining the date on which a corporation is organized for purposes of applying the provisions of IRC 508(a), the Service looks to the date the corporation comes into existence under the law of the state in which it is incorporated. One question that comes to mind with regard to the notice requirement relates to the practice of retroactively recognizing exemption back to the date of formation where an organization is required to amend its articles of incorporation in order to meet the organizational test set forth in Reg. 1.501(c)(3)-1(b). It can be argued that this practice is inconsistent with Reg. 1.508-1(a)(2)(iii), which states that an organization is "organized" on the date it first becomes an organization described in IRC 501(c)(3). An organization cannot be deemed described in IRC 501(c)(3) unless it has met the organizational test. Since an amendment is effective as of the date of its adoption, the organization could be considered described in IRC 501(c)(3) only from such date. Thus, for purposes of IRC 508(a), the 15-month period would begin with the date of amendment and, if an organization filed a properly completed and executed application within this period, its exemption would be effective from the date of amendment but not its date of formation or incorporation.

However, it has been a longstanding administrative practice that, if the sole bar to recognition of exemption for prior years is possible noncompliance with the organizational test of Reg. 1.501(c)(3)-1(b) and the organization amends its charter to comply with the organizational test, the exemption letter will be effective from the date of formation. See IRM 7668.12. Previously, Rev. Proc. 67-3, 1967-1 C.B. 560, also provided:

> An exemption ruling or determination letter is usually effective as of the date of formation of an organization if its purposes and activities during the period prior to the date of the ruling or determination letter were consistent with the requirements for exemption. If the organization is required to alter its activities or to make substantive amendments to its enabling instrument in order to

qualify for exemption, the exemption ruling or determination letter will be effective only for the period specified therein.

This principle was carried forward and republished in Rev. Proc. 72-4, 1972-1 C.B. 706.

In discussing the IRC 501(c)(3) organizational test, section 324 of the Exempt Organizations Handbook, IRM 7751, provides the following explanation with respect to certain practical applications of that test:

(1) Articles of Organization that fail to meet the organizational test are ordinarily amendable. After amendment, exemption may be retroactive to the period before amendment. Therefore, in most cases, the status of an organization depends ultimately on the operational test.

(2) This has several implications. The resolution of the organizational test question is only the first step in determining whether an organization is exempt. It is not a substitute for ascertaining the specific activities of an organization and determining whether they are within the scope of IRC 501(c)(3).

Consistent with the above, it has been and continues to be the practice of the Service to recognize an organization's exemption effective as of the date of formation, even though a non-substantive amendment of its governing instrument is necessary to satisfy the IRC 501(c)(3) organizational test. This result, of course, presupposes an organization's satisfaction of operational requirements from the date of its formation. Usually, the types of non-substantive amendments relate to the addition of a "non-inurement" clause, or "dissolution" clause, or clarifying language regarding the specific exempt purposes of the organization.

This practice may not accurately reflect state law with respect the effective date of amendments to a nonprofit corporation's articles of incorporation. In this regard, the law in a number of states provides that amendment to the articles of incorporation of a nonprofit corporation is effective upon the issuance of a certificate of amendment. Thus, in these jurisdictions, amendments may not be deemed to have retroactive effect. However, there may still be other jurisdictions that follow the doctrine of relation back, and, thus, may accord amendments to articles of incorporation retroactivity. In these jurisdictions, amended articles of

incorporation, when filed and issued in accordance with statutory authorization may relate back to, and become part of, the articles of incorporation. See Eickhoff and Schneider, Fletcher Cyclopedia of Law of Private Corporations, sec. 3729 (1978 rev.).

The practice of recognizing IRC 501(c)(3) exemption retroactively even though an organization is required to make non-substantive amendments to its governing instrument has, for many years, been strongly imbedded in the Service's administrative process. The underlying rationale for this practice is to avoid causing hardship to an organization that did not accurately state its real purpose, but did operate in an exempt manner since formation. Moreover, because this administrative practice has continued over the years, it would appear that a departure from it would result in inequitable and prejudicial treatment to new organizations. This would be the case, especially if the Service were to announce that it would not abide by what was its past announced administrative practice.

When one harmonizes this administrative practice with IRC 508(a), it becomes evident that the 15-month computation would begin with an organization's formation date even though a non-substantive amendment may have been adopted at a later date. A non-substantive amendment is deemed, as an administrative matter, to relate back to the date of an organization's formation. This would not be the case where a substantive amendment to a governing instrument was adopted.

The opposing view to this longstanding administrative practice has merit and is currently receiving consideration in the National Office. When final resolution of this issue has been completed, a revenue ruling will be published.

4. The Gross Receipts Exception Revisited

In the 1979 EOATRI, application of the three-year gross receipts test set forth in Reg. 1.508(a)-1(3)(ii) was illustrated. (See pp. 395-398 of that publication.) This three-year test has been interpreted to apply to organizations on a sliding basis. The purpose of this flexible rule is to except from the IRC 508 notice requirement organizations that may nominally exceed the statutory $5,000 guidelines in some but not all of their taxable years and yet remain within the aggregate $15,000 average established by the three-year test set forth in the regulations.

Further clarification of the application of the three-year test has recently been considered where, for example, an organization has satisfied the $7,500 gross receipts guideline in its first year of existence but has exceeded the aggregate $12,000 guideline by the end of its second tax year. The question presented is whether an organization, under these circumstances, will be recognized as exempt during its first year of existence if it does not file an application for exemption within 90 days after the end of its second taxable year. A similar issue arises where an organization is within the gross receipts exceptions during its first two years of existence, but exceeds the $15,000 limit at the end of the third tax year and does not file proper notice within the appropriate time period. Although this issue is currently pending in the National Office and has not been finally resolved, pro and con arguments are reviewed below.

IRC 508(a) of the Code provides, in part, that an organization organized after October 9, 1969, shall not be treated as an organization described in IRC 501(c)(3): (1) unless it has given notice to the Secretary or his delegate, in such manner as the Secretary or his delegate may by regulations prescribe, that it is applying for recognition of such status, or (2) for any period before the giving of such notice, if such notice is given after the time prescribed by the Secretary or his delegate by regulations for giving notice under this subsection.

IRC 508(c)(1)(B) of the Code provides that IRC 508(a) does not apply to any organization which is not a private foundation (as defined in IRC 509(a)) and the gross receipts of which in each taxable year are normally not more than $5,000.

Reg. 1.508-1(a)(3)(ii) provides that the gross receipts of an organization are normally not more than $5,000 if: (a) during the first taxable year of the organization the organization has received gross receipts of $7,500 or less; (b) during its first two taxable years the aggregate gross receipts received by the organization are $12,000 or less; and (c) in the case of an organization which has been in existence for at least three taxable years, the aggregate gross receipts received by the organization during the immediately preceding two taxable years, plus the current year are $15,000 or less.

Reg. 1.508-1(a)(3)(ii) further provides that if an organization fails to meet the requirements of (a), (b), or (c) of this subdivision, then with respect to the organization, such organization shall be required to file the notices described in IRC 508(a) and (b) within 90 days after the end of the period described in (a), (b), or (c). Thus, for example, if an organization meets the $7,500 requirement of (a) for its first taxable year, but fails to meet the $12,000 requirement of (b) for the

period ending with its second taxable year, then such organization shall meet the notification requirements if its files such notification within 90 days after the close of its second taxable year. If an organization which has been in existence at least three taxable years meets the requirements of (a), (b), and (c) with respect to all prior taxable years, but fails to meet the requirements of (c) of this subdivision with respect to the current taxable year, then even if the organization fails to make such notification within 90 days after the close of the current taxable year, IRC 508(a)(1) and 508(b) shall not apply with respect to its prior years. In such a case, the organization shall not be treated as described in IRC 501(c)(3) for a period beginning with such current taxable year and ending when such notice is given under section 508(a)(2).

Under one approach, if an organization comes within the safe harbors of Reg. 1.508-1(a)(3)(ii)(a) or (b), the organization is deemed not required, during its first year or first two years of existence, to file notice under IRC 508(a). Because notice is not required during this period, this approach provides that it would be illogical to deny exempt status (in the first year or first two years of existence) under IRC 501(c)(3) on the basis that the organization did not file a timely notice. Accordingly, an organization would be recognized exempt for the first year or first two years of existence when its gross receipts were within the safe harbors of the regulations but would not be exempt thereafter until proper notice was filed.

The second approach interprets the three-year test under Reg. 1.508-1(a)(3)(ii) as indivisible. IRC 508(c)(1)(B) applies only to organizations whose gross receipts are normally not more than $5,000, determined by a three year averaging test. Thus, an organization cannot satisfy the test unless it meets the test over a full three year period. Accordingly, where an organization failed, over its first three years of existence, to normally have $5,000 or less in gross receipts, it does not meet the exception of IRC 508(c)(1)(B). (Emphasis added.) Therefore, such an organization would not, for any period of time, be excepted from the IRC 508(a) notice requirement.

This approach interprets the 15-month rule as merely being extended throughout the first three years of existence so long as an organization's gross receipts remain within the safe harbor limits of Reg. 1.508-1(a)(3)(ii). This approach is supported by the sentence in the regulations that provides for an exception to the notice requirement only where Reg. 1.508-1(a)(3)(ii)(a), (b), and (c) are met. This conjunctive strengthens the argument that a full three year test is required to establish that an organization normally has gross receipts of $5,000 or less. (Emphasis added.)

As indicated above, both of these approaches are currently being considered in the National Office. Once adopted, a technical position will be published.

5. Withdrawal of Applications

Another recent issue considered in the National Office relates to the effect of IRC 508(a) notification requirements, when (1) a subordinate organization described in IRC 501(c)(3) withdraws from a group exemption or (2) an organization claiming IRC 501(c)(3) status withdraws a substantially complete exemption application from consideration.

In the case of subordinate organizations, a proposed position provides that the IRC 508(a) notification requirement does not have to be met where a subordinate organization withdraws from a group exemption and subsequently seeks to reestablish its exemption as an individual entity. This conclusion is based on the fact that such a subordinate organization has already notified the Service of its existence through the central organization.

However, a different proposal is being considered with respect to first-time individual applications. In this regard, when an organization withdraws its application, the Service has not yet established a record of the organization on any master file. In addition, there is usually insufficient information to make a determination as to the exempt status of the organization. Because of these consideration, it has been proposed that withdrawal of an application by an organization not previously included in a group exemption will void that submission as notice for purposes of IRC 508(a). As a consequence, in order to be recognized as exempt from the date of organization, a further application must be submitted to the Service within 15 months of the organizational date.

We propose to publish these conclusions.

6. IRC 508(e) and the Exemption Qualification of Private Foundations

Recently, the E.O. Technical Branch considered a proposed publication relating to the effect of the governing instrument provisions of IRC 508(e) on the exemption qualification of private foundations. "Does an organization that would be classified as a private foundation, if it were described in IRC 501(c)(3), satisfy the dissolution requirement set forth in Reg. 1.501(c)(3)-1(b)(4) by virtue of

having satisfied the governing instrument provisions of IRC 508(e)?" was the question presented.

Resolution of this issue was based on the recognition that IRC 508(e) applies only to private foundations and that a private foundation, as defined in IRC 509(a), is first an "organization described in IRC 501(c)(3)..." An organization that does not meet the requirements of Reg. 1.501(c)(3)-1(b)(4) as to dissolution is not "described in IRC 501(c)(3)." This requirement is a prerequisite for classification as a private foundation and, accordingly, is a condition precedent to the application of IRC 508(e).

The legislative history of IRC 508(e) and IRC 509(a) also makes it clear that the requirements set out in IRC 508(e) are additional to those found in section 501(c)(3). For example, see H. Rep. No. 91-413, Committee Report to the Tax Reform Act of 1969 (Part I), 91st Cong., 1st Sess. 40 (1969), 1969-3 C.B. 200, 226, which, in regard to "effective assurance... that the assets and organizational structure dedicated to charity will in fact be used for charity," states that:

> the bill provides as an additional condition of exemption for private foundations the requirement that the governing instrument require current distributions of income (sec. 4942) and prohibit self-dealing (sec. 4941), retention of excess business holdings (sec. 4943), speculative investments (sec. 4944), and taxable expenditures.... Your committee intends and expects that this requirement will add to the enforcement tools available to state officials charged with supervision of charitable organizations. (Emphasis added.)

See also S. Rep. No. 91-552, 91st Cong., 1st Sess. 56 (1969), 1969-3 C.B. 423, 460.

In view of the above, it was concluded that an organization does not satisfy the organizational test with respect to dissolution requirements set forth in Reg. 1.501(c)(3)-1(b)(4) by virtue of satisfying the governing instrument provisions applicable to private foundations under IRC 508(e). It is important to note that this holding does not apply to nonexempt charitable trusts that are private foundations by virtue of IRC 4947(a)(1), because IRC 4947(a)(1) treats them as described in IRC 501(c)(3) regardless of the dissolution provision.

This position should be published in the near future.