PART II

CURRENT DEVELOPMENTS

by
Toussaint Tyson and Conrad Rosenberg

I. Announcements and News Releases

1. Ann. 95-27, 1995-14 I.R.B. 15 (Apr. 3, 1995)

   Announces the most current update to Pub. 557, Tax-Exempt Status for Your Organization (Rev. Jan. 1995).

2. Ann. 95-51, 1995-25 I.R.B. 132 (June 19, 1995)

   Announces that the EP/EO determination letter program will be centralized, through a gradual process, in Cincinnati, Ohio. The public is reminded to submit requests for determination letters to the relevant key district offices until a further announcement is made.

3. Ann. 95-61, 1995-32 I.R.B. 54 (Aug. 7, 1995)

   Announces proposed examination guidelines for municipal financing arrangements and solicits public comments.

4. Ann. 96-13, 1996-12 I.R.B. 33 (Mar. 18, 1996)

   Implements a new program to develop procedures that would facilitate resolution of employment related issues including: record-keeping, employment taxes and worker classification.

5. Ann. 96-24, 1996-16 I.R.B. 30 (Apr. 15, 1996)

   Announces proposed examination guidelines for IRC 501(c)(12) rural electric cooperatives and solicits public comments.

6. IR 96-23 (Apr. 25, 1996)

   Reminds charitable organizations of the IRC 501(c)(3) proscription against intervention in political campaigns.

7. Ann. 96-33, 1996-18 I.R.B. 12 (Apr. 29, 1996)

   Announces a hearing on EE-53-95, which contains Prop. Reg. 1.501(c)(5)-1(b)(concerning the description of labor, agricultural and horticultural organizations).

8. Ann. 96-63, 1996-29 I.R.B. 1 (July 15, 1996)

   Announces that the processing of EO information and tax returns will be centralized, through a two-step process, in Ogden, Utah.

II. Notices and Revenue Procedures

1. Notice 95-47, 1995-35 I.R.B. 17

   This notice provides expedited treatment for exemption applications and temporary relief from certain Code provisions for organizations participating in Virginia flood relief.

2. Notice 95-56, 1995-45 I.R.B. 11

   This notice provides expedited treatment for exemption applications and temporary relief from certain Code provisions for organizations participating in Hurricane Marilyn relief in the Virgin Islands and Puerto Rico.

3. Notice 95-66, 1995-51 I.R.B. 19

   This notice provides expedited treatment for exemption applications and temporary relief from certain Code provisions for organizations participating in Hurricane Opal relief in parts of Alabama, Florida, and Georgia.

4. Notice 96-30, 1996-20 I.R.B. 11

   Notifies the public that an IRC 501(c) organization need not file the Form 3115 merely because the organization changes to the accounting methods specified in Financial Accounting Standards No. 116.

5. Rev. Proc. 95-21, 1995-1 C.B. 686

   Establishes when IRC 501(c)(5) associate member dues will be treated as gross income from an unrelated trade or business under IRC 512.

6. Rev. Proc. 95-35, 1995-32 I.R.B. 51

   Explains how tax-exempt organizations that lobby can establish exemption from the IRC 6033(e)(1) reporting requirements and the IRC 6033(e)(2) tax.

7. Rev. Proc. 95-48, 1995-47 I.R.B. 13, supplementing Rev. Proc. 83-23, 1983-1 C.B. 687

   In this revenue procedure, the Commissioner exercises her discretionary authority under Reg. 1.6033-2(g)(6) by specifying that neither governmental units nor affiliates of governmental units are required to file the annual information return, Form 990, Return of Organization Exempt from Income Tax.

8. Rev. Proc. 96-8, 1996-1 I.R.B. 187

   This revenue procedure supersedes Rev. Proc. 95-8, which contained the fee schedule for requests for letter rulings, determination letters, and certain other matters within the jurisdiction of the Assistant Commissioner (Employee Plans/Exempt Organizations), and replaces it with the new fee schedule.

9. Rev. Proc. 96-10, 1996-2 I.R.B. 17

   This procedure describes a class of organizations, affiliated with a church or convention or association of churches, and exempt from federal income tax under IRC 501(c)(3), that is not required to file the Form 990, Return of Organization Exempt from Income Tax. Rev. Proc. 83-23 is supplemented and Rev. Proc. 86-23 is obsoleted. (See reference to TD 8640, below.)

10. Rev. Proc. 96-15, 1996-3 I.R.B. 41

    Concerns a procedure a taxpayer may follow to request from the Service a Statement of Value, a reliance document, that can be used to substantiate the value of art for specific purposes such as the charitable contributions deduction under the Code.

11. Rev. Proc. 96-32, 1996-20 I.R.B. 14, supersed'g Notice 93-1, 1993-1 C.B. 290

    Provides guidance, for organizations providing low-income housing, on qualifying for tax-exemption under IRC 501(c)(3). The revenue procedure creates a safe-harbor rule that permits these organizations to offer a limited number of units to persons with income above the low-income limits.

III. Regulations

1. T.D. 8602, 1995-34 I.R.B. 5

   This document contains final regulations, modifying Reg. 1.162-20(c), adding Regs. 1.162-28 and 1.162-29, and removing Reg. 1.162-20T, and thereby provides guidance on complying with IRC 162(e)(3)(concerning the disallowance of an IRC 162 deduction for certain amounts paid by a taxpayer and allocable to an exempt organization's "influencing legislation.") This document includes guidance on the meaning of the term "influencing legislation" and on acceptable methods to allocate payments into deductible and nondeductible portions.

2. IA-44-94, 1995-37 I.R.B. 41, 60 Fed. Reg. 39896

   These proposed regulations, Prop. Regs. 1.170A-1(h), 1.170A-13, and 1.6115-1, provide guidance regarding the allowance of certain charitable contribution deductions, the substantiation requirements for charitable contributions of $250 (or more), and the quid pro quo contributions in excess of $75.

3. T.D. 8615, 1995-39 I.R.B. 5

   Provides guidance for determining whether certain scholarships, prizes and awards, fellowship grants and other grants (including those

described in IRC 4945(g)) are U.S. sourced and, therefore, subject to the income tax and withholding.

4. T.D. 8623, 1995-45 I.R.B. 4

   This document contains final regulations 1.170A-13(f), and addresses the substantiation of contributions made by payroll deduction and the substantiation of a payment to a donee organization in exchange for goods or services with insubstantial value.

5. T.D. 8628, 1995-52 I.R.B. 9

   This document containing final regulations amends Regs. 53.4955-1, 53.6011-1, 53.6012-1, 53.6071-1, 53.6091-1, 301.6213-1, 301.6852-1, 301.6861-1 and 301.6863-2 concerning excise taxes, filing returns, and accelerated tax assessments relating to certain political expenditures of charitable organizations; it also amends Reg. 301.7409-1, which concerns an action to enjoin certain political expenditures made by charitable organizations. This Treasury Decision implements an effort to effectuate changes made to the Code by OBRA '87.

6. T.D. 8640, 1996-2 I.R.B. 10

   This document finalizes, with some modifications arising from public comment, proposed regulations under IRC 508 and 6033, which had been published as EE-41-86, 1995-1 C.B. 841, 59 Fed. Reg. 64633. The regulation concerns integrated auxiliaries of churches and their exemption from filing information returns.

7. T.D. 8639, 1996-5 I.R.B. 12

   This document contains final regulations modifying Reg. 53.4941(d)-2, which provides that it will not generally be considered IRC 4941 self-dealing if a private foundation provides non-compensatory insurance or indemnification for the foundation manager against civil actions for misconduct arising out of actions the manager performed on behalf of the foundation. This regulation also describes when the indemnification and insurance payments would be considered compensatory or non-compensatory. ("Directors and Officers" insurance issue.)

8. EE-53-95, 1996-5 I.R.B. 23, 60 Fed. Reg. 66228

   This notice of proposed rulemaking contains a proposed regulation that may amend Reg. 1.501(c)(5) to clarify that the term "labor, agricultural and horticultural organizations" as that term is used in IRC 501(c)(5), does not include organizations principally engaged in managing retirement plans.

9. INTL-62-90, etc., 1996-19 I.R.B. 26, 61 Fed. Reg. 17614

   Prop. Reg. 1.1441-1(f)(3) provides guidance concerning payors' withholding requirements relating to qualified scholarships (as defined in IRC 117(a)) made to non-resident aliens, if such scholarships are U.S. sourced. Prop. Reg. 1.1441-9 provides guidance relating to the withholding rules applicable to certain foreign tax-exempt organizations (including private foundations).

IV. Court Decisions

1. Texas Farm Bureau v. United States, 53 F.3d 120 (5th Cir. 1995), rev'g (in part) 822 F.Supp. 371 (W. D. Tex. 1993)

   Texas Farm Bureau, an organization described in IRC 501(c)(5), had partial interests in two insurance companies and had entered into profitable agreements with both to provide, for a fee, administrative services and the exclusive right to use its name and logo in Texas. These agreements did not mention a royalty. For each of the litigated years, TFB filed timely returns reporting the fees as unrelated business taxable income and subsequently filed amended returns, unsuccessfully arguing to the Service that part of the fees was an IRC 512(b)(12) royalty. The District Court let the jury decide that part of the fees was a royalty; the Fifth Circuit reversed the District Court ruling that TFB's post hoc amended returns are insufficient evidence, as a matter of law, to show that the fees were, in part, royalties.

2. Southwest Texas Electrical Cooperative, Inc. v. Commissioner, 67 F.3d 87 (5th Cir. 1995), aff'g T.C. Memo 1994-363

   The Tax Court ruled that the exempt organization generated IRC 514 debt-financed income because it earned interest income from United States treasury notes purchased with borrowed funds where the court

found that the organization would not have purchased the treasury notes but for the incurred debt. The Fifth Circuit affirmed.

3. Florida Hospital Trust Fund v. Commissioner, 71 F.3d 808 (11th Cir. 1996), aff'g 103 T.C. 140 (1994)

   Three trust funds, which were established to provide malpractice and workers' compensation on a cooperative basis to Florida hospitals, were denied exemption because (1) they provided commercial-type insurance and, therefore, were precluded from exemption by IRC 501(m), and (2) although the **purchase** is, the **provision of** malpractice and workers' compensation is not a prescribed IRC 501(e)(1)(A) activity, and, therefore, none of the trusts could qualify for exemption under IRC 501(e). The Eleventh Circuit upheld the Tax Court's ruling on the IRC 501(e) issue and made no decision on the Tax Court's IRC 501(m) ruling.

4. Credit Union Insurance Corporation v. United States, 77 AFTR2d ¶ 96-712 (4th Cir. 1996), aff'g 75 AFTR2d 95-2507 (D.C. Md. 1995)

   Insurance Corporation, which was chartered under state law, insured the deposits of several state credit unions and successfully applied for recognition as a business league. However, the Service, relying on Rev. Rul. 83-166, 1983-2 C.B. 66, which posits that certain credit union insurers are specifically precluded exemption by IRC 501(c)(14)(B) and, therefore, cannot circumvent that proscription by claiming to be described in IRC 501(c)(6), revoked Insurance Corporation's exemption. The district court held for Insurance Corporation.

   The Fourth Circuit rejected the revenue ruling's reasoning and then ruled that insuring credit union deposits is not the kind of business that a for-profit business would or could engage in and, therefore, held for Insurance Corporation.

5. National League of Postmasters of the United States v. Commissioner, 77 AFTR2d ¶ 96-713 (4th Cir. 1996), aff'g T.C. Memo 1995-205

   National League of Postmasters is a labor organization whose purpose, as stated in its articles of incorporation, is to improve the working conditions of its members, of which it had two basic classes. One class' membership was affiliated with the postal system; and the second was affiliated with non-postal federal employment. The members of the second class, League Benefit Members (LBM's), paid dues and service

fees, which the Service determined to be unrelated business taxable income of the National League of Postmasters. The Tax Court upheld this determination.

The Fourth Circuit upheld the Tax Court's ruling that "members" as used in the League of Postmasters' articles of incorporation meant postmasters and (to a lesser extent) other postal workers. Thus, any service provided to other federal workers, LBM's or not, was unrelated to National League of Postmasters' exempt purpose. Further, the Fourth Circuit ruled that many of the benefits provided to the non-postal federal workers, even if such workers were bona-fide members, "failed to provide for the betterment of conditions for all federal employees."

6. Sierra Club, Inc. v. Commissioner, 78 AFTR2d ¶ 96-5002 (9th Cir. 1996), aff'g T.C. Memo 1993-199, rev'g 103 T.C. 307 (1994)

The Ninth Circuit upheld the Tax Court's decision of Sierra Club I (T.C. Memo 1993-199), which held SC's receipts from third party use of its mailing lists were IRC 512(b) royalties, and reversed and remanded Sierra Club II (103 T.C. 307), which held that SC's participation in an affinity card program would not generate unrelated business taxable income because the resulting receipts are IRC 512(b) royalties.

The Ninth Circuit decision is important because it appears to narrow the definition of royalty so that virtually any activity, seemingly even mere maintenance of a mailing list, could preclude IRC 512(b) royalty treatment of the related payment.

7. Lucky Stores, Inc. & Subs. v. Commissioner, 105 T.C. 420 (1995)

Lucky Stores donated bread, and other baked goods, to charity four days after baking, except on Sunday, when such four-day old bread would be sold for full retail value. Lucky Stores claimed charitable deductions under Reg. § 1.170A-1(c)(2)(basis plus one-half the ordinary gain determined at full retail value); the Service argued Lucky Stores must determine its charitable deduction under Treas. Reg. § 1.170A-(c)(3)(basis plus one-half the ordinary gain determined at a discounted value). The Tax Court ruled that Lucky Stores was entitled to use Reg. § 1.170A-(c)(2).

8. Ohio Farm Bureau Federation, Inc. v. Commissioner, 106 T.C. No. 11 (1996)

   Farm Bureau Federation had a services contract with a farmers' cooperative, and subsequently entered into a covenant not to compete with that cooperatives' successor. The Service determined that the services contract and the covenant generated unrelated business income tax; the Tax Court upheld the Farm Bureau Federation.

   The Tax Court found that promotion of the cooperative was substantially related to Farm Bureau Federation's exempt purpose. Further the Tax Court found that performance under a covenant not to compete is not an IRC 513 trade or business and that the one-time entrance into a one-time covenant not to compete is not a "regularly carried on" activity.

9. Julius M. Israel Lodge of B'nai B'rith #2113 v. Commissioner, T.C. Memo 1995-439

   The Tax Court upheld the Service's determination that "instant bingo" is not an IRC 513(f) "bingo game," which denotes a game where the winners are determined and the distribution of prizes is made in the presence of all persons placing wagers. The court had found that under the relevant local law the "instant bingo" operator need not determine the winners nor distribute the prizes in the presence of all persons placing wagers in the game. Therefore, the Lodge's proceeds from instant bingo are subject to the unrelated business income tax under IRC 511(a).

10. Deer Park Country Club v. Commissioner, T.C. Memo 1995-567

    The club, described in IRC 501(C)(7), rented its 63.8 acre tract of land as farmland. During this lease term, the club decided to develop the tract for recreational uses, and engaged a layout designer to develop the necessary plans. Later, during the financing negotiations, the club was required by the lending banks to sell some of the land as homesites; the taxpayer so sold 4.8 acres. The Service determined that the proceeds were subject to the unrelated business income tax under IRC 512(a)(3)(A); the club argued that it had manifested an intent to use the entire 63.8 acres of property in the performance of its exempt function and that the proceeds were subject to the nonrecognition rules of IRC 512(a)(3)(D), which except from UBTI the gain on sales of property used for the club's exempt function if the property is replaced within three

years for the same purpose. The Tax Court found that IRC 512(a)(3)(D) requires that the property be used (not merely intended for use) in the performance of its exempt function, that the taxpayer had not so used the property, and consequently, the court upheld the Service's position with respect to the gain on the sale of the 4.8 acres.

11. Oregon State University Alumni Association, Inc. v. Commissioner, T.C. Memo 1996-34

    The Tax Court relying heavily on Sierra Club, Inc. v. Commissioner, 103 T.C. 307 (1994)(Sierra Club II) ruled that payments received from a bank by an IRC 501(c)(3) alumni association for its participation in an "affinity credit card" program were not unrelated business taxable income. Instead, the Tax Court concluded that the association's income was received in exchange for the use of valuable intangible property rights, i.e. the association's mailing list, endorsement and logo. The court concluded in addition that it should not be inferred that the passage of IRC 513(h), which excepts certain rentals of mailing lists from unrelated business taxable income, was intended to imply that all list rentals not so excepted were intended to be taxed. Further, the court considered the association's services promotive of the affinity card program to be de minimis, when compared to the services performed by the organization in Disabled American Veterans v. United States, 942 F.2d 309 (6th Cir. 1991), rev'g 94 T.C. 60 (1990), for the tax years involved. The activities included the printing and mailing of promotional materials to 66,432 alumni in one of the years at issue. (The recent Ninth Circuit Sierra Club II decision puts the precedential value of this case into question.)

12. Alumni Association of the University of Oregon, Inc. v. Commissioner, T.C. Memo 1996-63

    The Tax Court relying heavily on Sierra Club, Inc. v. Commissioner, 103 T.C. 307 (1994)(Sierra Club II) and Oregon State University Alumni v. Commissioner, T.C. Memo 1996-34 ruled that payments received from a bank by the IRC 501(c)(3) alumni association for its participation in an "affinity credit card" program were not unrelated business taxable income. Instead, the Tax Court concluded that the association's income was received in exchange for the use of valuable intangible property rights, i.e. its mailing list, endorsement and logo. The court concluded in addition that it should not be inferred that the passage of IRC 513(h), which excepts certain rentals of mailing lists from unrelated business taxable income, was intended to imply that all list rentals not so excepted

were intended to be taxed. Further, the court considered the taxpayer's services promotive of the affinity card program to be de minimis for the tax years involved. (The recent Ninth Circuit decision in Sierra Club II puts the precedential value of this case into question.)

13. Stephen D. Ruddel v. Commissioner, T.C. Memo 1996-125

    The Tax Court ruled that $80,000 paid to the police as part of the taxpayer's plea agreement was not a charitable contribution. Payments that proceed from a legal obligation are not a charitable gift. The taxpayer's plea agreement related to his narcotics trafficking activity.

14. Bob Jones University Museum and Gallery v. Commissioner, T.C. Memo 1996-247

    The Tax Court ruled against the Service's denial of the Museum's charitable status. The Museum absorbed the museum functions of Bob Jones University, an organization not described in IRC 501(c)(3). The court, limiting its analysis to the case's specific facts, ruled that where the Museum's activities promote education, the Museum is independent of the University, and the Museum pays fair market rates for services provided by the University, the Museum is described in IRC 501(c)(3).

15. University Medical Resident Services, P.C. and University Dental Resident Services, P.C. v. Commissioner, T.C. Memo 1996-251

    The Tax Court upheld the Service's denial of charitable status for the petitioners, UMRS and UDRS, which were nonprofit professional corporations established to aid certain medical and dental residency programs in upstate New York. A charitable organization administered the residency programs, the teaching hospitals handled the training, and medical schools supervised the quality of the teaching program. The petitioners, which had no administrative staff, paid the residents' compensation and had nominal power to hire and fire the residents.

    The petitioners argued they were charitable because they (1) advanced education; (2) lessened the burdens of the local government; and (3) were educational under the integral part theory. The court ruled that the petitioners' advancement of education was minimal; that the petitioners had failed to establish that either the medical schools or the teaching hospitals were governmental entities or that the petitioners reduced the cost of the training in any event; and that petitioners were merely shell

corporations providing the conduit through which compensation might be made to the medical and dental residents. Accordingly, the petitioners could not be conducting the integral functions of any charitable organizations.

16. The Church of the Living Tree v. Commissioner, T.C. Memo 1996-291

    In an IRC 7428 action, the Tax Court upheld the Service's determination that the organization, whose secondary purpose was promotion of the (hand) papermaking industry, was not described in IRC 501(c)(3). The organization also provided rent-free facilities to the founder, although the founder received no compensation for his work with the organization. The Service had determined that promotion of the papermaking industry was a substantial non-exempt purpose and that the organization provided private benefit to the founder. The court ruled that the organization had not carried its burden of proof to show the Service's determination was erroneous.

V. Bills Introduced or Passed During the 104th Congress

1. P.L. 104-117, 110 Stat. 827 (1996). This legislation extends the Service's user fee authority until October 1, 2003. Also confers "combat zone" status to American soldiers in the former Republic of Yugoslavia.

2. P.L. 104-168, 110 Stat. 1452 (1996) (Taxpayer Bill of Rights II) **(See copy of the Act, H.R. Rep. No. 506 104th Cong., 2nd Sess. 53 and an explanation of the Act at the end of this article)**

   Section 904 provides that the IRC 6672 penalty (concerning the willful failure to collect and pay over tax) is inapplicable to certain unpaid, volunteer boardmembers of tax-exempt organizations.

   Section 1311 (1) imposes a two-tier intermediate sanction excise tax on persons with substantial influence over an IRC 501(c)(3) organization if that person engaged in a transaction resulting in an excess benefit to such person and (2) adds new IRC 501(c)(4)(b), an anti-inurement provision similar to the anti-inurement provision of IRC 501(c)(3).

   Section 1312 increases the IRC 6033 reporting requirements applicable to organizations subject to the new intermediate sanction excise tax.

Section 1313 amends IRC 6104(e)(concerning the public inspection of annual returns and exemption applications) to require certain tax-exempt organizations to make copies of certain returns and exemption applications available to requesters; the amendment includes a provision to protect the affected exempt organizations from harassment campaigns.

Section 1314 increases the IRC 6652(c)(1) penalty applicable to organizations that fail to file timely and complete information returns.

3. H.R. 32. Among many other things relating primarily to estates and trusts, would provide for annual notice to charitable beneficiaries of their interests in charitable remainder trusts. The bill would also provide sanctions to encourage compliance.

4. H.R. 733. Would amend the Code to facilitate contributions to foreign private foundations and extend the due date for first quarter estimated tax by private foundations.

5. H.R. 1121. Section 13221 of the bill would clarify the IRC 6033(e)(1) reporting requirements of IRC 527 organizations.

6. H.R. 1299. Among other things relating primarily to insurance companies, this bill would provide exemption under IRC 501(c)(3) to an organization operated and organized solely to pool insurable member risk if the organization otherwise met the requirements of IRC 501(c)(3).

7. H.R. 1575. A bill to increase the amount of the charitable contribution deduction, and to allow such deduction to individuals who do not itemize.

8. <u>H.R. 2491 (Balanced Budget Act of 1995; vetoed)</u>

   Section 11271 would (1) impose a two-tier intermediate sanction excise tax on any person with substantial influence over an IRC 501(c)(3) or IRC 501(c)(4) organization if that person engaged in a transaction resulting in an excess benefit to such person and (2) add new IRC 501(c)(4)(b), an anti-inurement provision similar to the anti-inurement provision of IRC 501(c)(3).

   Section 11272 would increase the IRC 6033 reporting requirements applicable to organizations subject to the new intermediate sanction excise tax.

Section 11273 would increase the additions to tax, of IRC 6652(c)(1)(relating to annual returns required by IRC 6033), on organizations failing to file complete and timely returns.

Section 11276 would create a new IRC 501(n) which would treat certain cooperative service organizations as IRC 501(c)(3) charitable organizations, if such organizations are organized and operated for cooperative investment purposes and meet other requirements.

Section 11277 would add IRC 513(i) to provide that the term "unrelated trade or business" does not include certain corporate sponsorship payments.

Section 11278 would add IRC 512(d) to the Code to exclude from the unrelated business taxable income of organizations defined in IRC 501(c)(5) the receipt of required dues if the required dues do not exceed $100 (indexed for inflation).

Section 11377 would add IRC 512(b)(18) to the Code which would provide that unrelated business taxable income includes Subpart F (IRC 951(a)(1)(A)) insurance income.

9. H.R. 2676. This bill would provide, under IRC 1042, for the nonrecognition of gain attributable to the sale of stock to certain Subchapter T farmers' cooperatives.

10. H.R. 2741. A bill to include within the definition of IRC 1361 S-Corporation, an ESOP trust, and to make conforming changes to IRC 513 and IRC 512.

11. H.R. 2864. This bill would provide for IRC 501(c)(3) bonds a tax treatment similar to that available to governmental bonds.

12. H.R. 2910. This bill would amend the Code to allow IRC 501(c)(3) organizations to engage in a de minimis amount of electioneering.

13. H.R. 2919. This bill concerns the development and use of "brownfields," abandoned industrial sites in need of cleanup, and would provide that certain organizations, so-called "Hazardous Waste Remediation Reserves," be treated as trusts described in IRC 501(c)(21) (describing Black Lung Trusts).

14. H.R. 2994. Would extend some expiring tax provisions including employer provided educational assistance. Additionally, the bill would eliminate IRC 170(e)(5).

15. H.R. 3103. (In Conference) This bill, designed to improve portability of health insurance coverage, would describe, under new IRC 501(c)(26), a state sponsored membership health plan for the state's residents who are otherwise unable to acquire medical insurance for certain reasons.

16. H.R. 3448 (Small Business Job Protection Act: In Conference).

    Section 1114 would add IRC 501(n) to the Code providing for the tax-exempt status of certain charitable risk insurance pools that are exempt from state taxation and whose members are exclusively charitable organizations.

    Section 1115 would exempt from the unrelated business income tax required annual dues if they are $100 or less and paid to an organization described in IRC 501(c)(5) (describing labor, agricultural and horticultural organizations). The provision includes indexing for inflation.

    Section 1603 would treat as unrelated business income certain insurance income derived by a tax-exempt organization if that income is also described as IRC 951(a)(1)(A) insurance income.

17. S. 112. This bill would treat income for IRC 501(c)(12) from a nonmember telephone company as either member income or excludable from the IRC 501(c)(12)(i) 85% analysis. The bill would also amend IRC 512(c)(12) to provide more favorable treatment of certain investment income of such telephone companies.

18. S. 789. Would eliminate the IRC 170(e)(5)(D) limitation on contributions of appreciated publicly traded stock to private foundations and amend IRC 4942(g)(2) to facilitate private foundation grants to foreign organizations that are themselves treated as private foundations.

19. S. 793. Would amend IRC 501 to provide exemption from income tax for some common investment funds.

20. S. 846. Would allow a tax credit for charitable contributions to certain kinds of private charities providing assistance to the poor.

21. S. 1538. A bill to define the term "qualified medical entity" and to extend favorable treatment, under IRC 457(c)(2), to certain pension plans maintained by such entities.

22. S. 1568. A bill to "extend" several expired tax provisions including IRC 120 (concerning amounts received under qualified group legal services plans), IRC 127 (concerning employer-provided educational assistance programs) and IRC 170(e)(5)(D)(concerning appreciated publicly traded stock contributed to a private foundation).

The following is a copy of the "Intermediate Sanctions" portion of P.L. 104-178, 110 Stat. 1412 (popularly known as Taxpayer Bill of Rights 2) as passed by the House and Senate.

Subtitle B-Exicse Taxes on Amounts of Private Excess Benefits

Taxpayer Bill of Rights 2, Pub. L. No. 104-168, 110 Stat. 1452, (the Act) was enacted July 30, 1996. The Act amended various provisions of the Internal Revenue Code. This discussion summarizes aspects of the Act related to excise taxes (so-called Intermediate Sanctions) on excess benefit transactions, extension of the inurement prohibition to §501(c)(4) organizations, the increased disclosure requirement, changes to the §6033 filing requirements, and increased disclosure and failure to file penalties. This overview cannot answer all questions raised by the new provisions, as many issues will need to be clarified by regulations or other guidance. We are currently working with Chief Counsel and the Office of Tax Legislative Counsel to develop the needed guidance.

I. Excise Taxes On Excess Benefit Transactions In General

Section 1311(a) of the Act creates new §4958, which imposes excise taxes on excess benefit transactions. An **excess benefit transaction** subject to tax under §4958 is any transaction in which an economic benefit is provided by an organization described in §501(c)(3) (except for a private foundation) or 501(c)(4) directly or indirectly to, or for the use of, any disqualified person if the value of the economic benefit provided exceeds the value of the consideration (including the performance of services) received for providing the benefit. Revenue sharing arrangements will be included in the definition of excess benefit transactions "to the extent prescribed in regulations, but only if the arrangement would constitute inurement under §§501(c)(3) and 501(c)(4)." A **disqualified person** is any person who was, at any time during the 5-year period ending on the date of the excess benefit transaction, in a position to exercise substantial influence over the affairs of the organization, even if such person is an employee of the organization's subsidiary, and not an employee of the organization. Disqualified persons also include family members and certain entities in which at least 35 percent of the control or beneficial interests are held by disqualified persons. An **organization manager** is an officer, director, trustee, or any individual having powers or responsibilities similar to those of an officer, director, or trustee.

There are three taxes under §4958:

> (1) pursuant to §4958(a)(1), a tax equal to 25 percent of the excess benefit amount which shall be paid by any disqualified person who engages in an excess benefit transaction with a §501(c)(3) (except for a private foundation) or §501(c)(4) organization;

> (2) a tax equal to 200 percent tax of the excess benefit amount which shall be paid by any disqualified person if the excess benefit transaction is not corrected within the taxable period (§4958(b)). The taxable period runs from the date the transaction occurs to the time the 90 day letter is mailed or the intermediate sanctions tax is assessed, whichever is first; and
>
> (3) pursuant to §4958(a)(2), a tax equal to 10 percent of the excess benefit of the excess benefit amount which shall be paid by any organization manager who knowingly participates in an excess benefit transaction.

There is no second tier tax on the organization manager whose role in the transaction is not that of a disqualified person. The tax to be paid by an organization manager shall not exceed $10,000. The taxes on excess benefit transactions are eligible for abatement under the general abatement rules of §§4961 and 4962.

Effective Date

The §4958 excise taxes apply to excess benefit transactions occurring on or after September 14, 1995. They do not apply, however, to any benefit arising from a transaction pursuant to any written contract that was binding on September 13, 1995, and continued in force through the time of the transaction.

II. Private Inurement Expressly Prohibited for §501(c)(4) Organizations

The Act also amends §501(c)(4) to expressly prohibit inurement of any part of the net earnings of an entity otherwise described in that section to the benefit of any private shareholder or individual. That amendment applies to inurement occurring on or after September 14, 1995. The provision does not apply, however, to inurement occurring prior to January 1, 1997, if that inurement results from a written contract that was binding on September 13, 1995, and continued in force through the time that the inurement occurred. (The statute also contains a grandfather provision for certain arrangements of cooperatives recognized under §501(c)(4). We expect this provision, which is not codified, to have very narrow applicability.)

III. Returns for Payment of Excise Taxes

Charities and other persons liable for certain Chapter 41 or Chapter 42 excise taxes must file returns on Form 4720 to calculate and report the taxes

due. This form, as revised for 1996, will be used to calculate the excise taxes imposed on excess benefit transactions by §4958.

IV. Other Reporting Requirements for §4958 Excise Taxes

Section 1312(a) of the Act amends §6033(b) to require §501(c)(3) organizations to report the amounts of the taxes paid under §4958 with respect to excess benefit transactions involving the organization, as well as any other information the Secretary may require concerning those transactions. Section 6033(f) is also amended to impose this same filing requirement on §501(c)(4) organizations. These amendments only apply to returns for taxable years beginning after July 30, 1996, the date of enactment of the Act. Accordingly, affected organizations are not required to file amended returns to include information on taxes paid under §4958, or any other information that may be required with respect to excess benefit transactions, for their taxable years ending before July 30, 1996.

V. Disclosure Requirements Related to Annual Information Returns

Section 1313(a) of the Act amends §6104(e)(1) with regard to the manner in which an exempt organization (other than a private foundation) must disclose its annual information return to the public. Prior law required tax-exempt organizations to show a requester copies of the organization's three most recent annual information returns at the organization's place of business. Although prior law required the organization to allow inspection of the returns and required the organization to allow the requester to take notes while inspecting the returns, it did not require the organization to provide a photocopy that the requester could take from the organization's office.

The following two rules, as well as the penalties for failure to comply with them, do not become effective until relevant regulations are promulgated. However, the Service is encouraging voluntary compliance with these new disclosure rules. First, §6104(e)(1)(A), as amended, provides that if a person requests a copy of one or more of the three most recent information returns, either in person or in writing, the organization must provide the copies to the requester without charge other than a reasonable fee for any reproduction and mailing costs. If the request is made in person, the copies must be provided immediately. If the request is made in writing, the copies must be provided within 30 days.

Second, §6104(e)(2)(A), as amended, applies this rule to the exempt organization's application for recognition of exemption under §501(a) (together

with a copy of any papers submitted in support of such application and any letter or document issued by the Service with respect to such application).

Under new §6104(e)(3), the new requirement to provide copies without charge (other than a reasonable fee for any reproduction and mailing costs) does not apply if, in accordance with regulations promulgated by the Secretary, the organization has made the requested documents widely available. Neither does the new §6104(e)(3) requirement apply if the Secretary determines, upon application by the organization, that the request is part of a harassment campaign and that compliance with the request is not in the public interest.

VI. Increases in Certain Penalties

Section 1313(b) of the Act amends §6685 to increase the penalty for a willful failure to allow inspection of any return or application for exemption under §§6104(d) or (e) from $1,000 to $5,000. The amendment to §6685 does not take effect until 60 days after the Secretary of the Treasury first issues regulations under new §6104(e)(3).

Section 1314(a) of the Act amends §6652(c)(1) to increase the penalties on exempt organizations for failure to file complete and timely annual information returns. Section 6652(c)(1), as amended, also provides that a failure to file an annual information return, failure to include any of the information required to be shown on the return, or failure to show the correct information, results in a penalty to be paid by the organization of $20 per day (increased from $10 per day under prior law) for each day during which the failure occurs. The maximum penalty under §6652(c)(1) with respect to any one return shall not exceed the lesser of $10,000 (increased from $5,000) or 5 percent of the gross receipts of the organization for the year.

Section 1314(b) of the Act creates a new special penalty for large organizations under §6652(c)(1). Under this provision, a failure to file an annual information return, failure to include any of the information required to be shown on the return, or failure to show the correct information by an exempt organization with **gross receipts** exceeding $1,000,000 for any year results in a penalty to be paid by the organization of $100 per day for each day during which the failure occurs. The maximum penalty under §6652(c)(1) for an organization with gross receipts exceeding $1,000,000 shall not exceed $50,000.

The amended penalties in §6652(c)(1) apply to returns for taxable years ending on or after July 30, 1996.

Until further guidance is issued, you should address all questions concerning TBOR2 issues to Toussaint Tyson in Projects Branch 1 (CP:E:EO:P-1) at (202)622-8363.