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Report #1341
April 11, 2016

The Honorable Mark Mazur
Assistant Secretary (Tax Policy)
Department of the Treasury
1500 Pennsylvania Avenue, NW
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The Honorable John Koskinen
Commissioner
Internal Revenue Service
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Washington, DC 20224

The Honorable William J. Wilkins
Chief Counsel
Internal Revenue Service
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Re: *New Section 506*

Dear Messrs. Mazur, Koskinen and Wilkins:

This letter[1] requests that regulations issued under new section 506 clarify that (i) an organization that in good faith intends to operate as a section 501(c) organization other than a section 501(c)(4) organization need not notify the Internal Revenue Service (the "**IRS**") under section 506 unless that intent changes, even if the organization is also described in section 501(c)(4);

[1] The principal drafter of this letter was David S. Miller, with significant assistance from Richard R. Upton. Comments were received from Jean Bertrand, Kimberly S. Blanchard, Peter J. Connors, Harvey Dale, Joshua E. Gewolb and Stephen B. Land. This letter reflects solely the views of the Tax Section of the New York State Bar Association ("**NYSBA**") and not those of the NYSBA Executive Committee or the House of Delegates. Unless otherwise indicated, all references to section numbers are to the Internal Revenue Code of 1986, as amended.

and (ii) a foreign organization described in section 501(c)(4) need not file the notice required by section 506 if it has no significant activities in the United States.

I. Background

Section 501(a) generally provides that an organization described in section 501(c) is exempt from federal income tax. Section 501(c)(4) describes organizations that are "operated exclusively for the promotion of social welfare." Section 501(c)(4) organizations (unlike section 501(c)(3) organizations) do not entitle their donors to a charitable deduction but are permitted to engage in an unlimited amount of lobbying activity and some amount of political activity. A section 501(c)(4) organization's donor information is not subject to public disclosure. Section 501(c)(4) organizations include a wide variety of organizations large and small, such as garden clubs,[2] not-for-profit roller skating rinks[3] and the AARP,[4] including organizations that engage in lobbying and/or political activity.[5]

There is no requirement that a section 501(c)(4) organization apply to the IRS for recognition of its tax-exempt status (other than the case of an organization that seeks reinstatement of exempt status after it has failed to file annual returns or notices for three consecutive years).[6] However, practitioners report that the IRS strongly encourages all groups claiming tax-exempt status to apply for recognition of that status.[7]

Prior to the Protecting Americans from Tax Hikes Act of 2015 (the "**PATH Act**"),[8] a not-for-profit organization could be organized, take the position that it was a section 501(c)(4) organization, engage in political activities, and then dissolve before its first tax return was re-

[2] Rev. Rul. 66-179, 1966-1 C.B. 139.

[3] Rev. Rul. 67-109, 1967-1 C.B. 136.

[4] The American Association of Retired People is the largest 501(c)(4) organization by gross receipts and the second largest by total assets. National Center for Charitable Statistics, Organizations by IRS Subsection, *available at* http://nccsweb.urban.org/PubApps/showOrgsByCategory.php?group=subsection&code=04 (last visited on Mar. 1, 2014).

[5] National Public Radio, *Social Welfare Organizations Play Big Role in Presidential Politics* (July 7, 2012), *available at* http://www.npr.org/sections/itsallpolitics/2012/07/07/156381618/social-welfare-organizations-play-big-role-in-presidential-politics.

[6] Section 6033(j)(2).

[7] *See* David van den Berg, *EOs May Not Know Exemption Applications Often Aren't Required*, 2013 TAX NOTES TODAY 111–19 (June 10, 2013).

[8] Pub. L. 114-113 (2015).

quired to be filed, without the IRS having received any notice that the organization existed. These organizations were known as "pop-up (c)(4)s."[9]

Section 405 of the PATH Act enacted new section 506. Section 506 requires an organization that is described in section 501(c)(4) and organized after December 18, 2015 (the date of the enactment of the PATH Act) to notify the IRS within 60 days after the organization is established of its intent to operate as a section 501(c)(4) organization.[10] An organization that was organized on or before December 18, 2015, that has not applied for written recognition as a section 501(c)(4) organization, and has not filed at least one annual tax return (IRS Form 990) must notify the IRS by June 15, 2016 that it is operating as a section 501(c)(4) organization.[11] (Section 501(c)(4) organizations that were organized on or before December 18, 2015 and have either applied for a written determination of their status or filed at least one Form 990 are not required to notify the IRS under section 506.)

Failure to file the notice potentially subjects the organization to a penalty of $20 per day (but not more than $5,000) and, if the organization has failed to file the notice after the IRS makes a written demand, the managers of the organization (*i.e.*, its officers and directors) are potentially subject to additional penalties of $20 per day (not to exceed $5,000 in the aggregate).[12]

Section 506 was first introduced into Congress on November 18, 2013 by Rep. Charles W. Boustany, Jr., M.D. (R-La.), apparently in reaction to the significant delay by the IRS in processing the tax-exemption applications of certain section 501(c)(4) organizations in connection with the 2012 Presidential election. Section 506 was next introduced on March 4, 2015 by Rep. George Holding (R. N.C.). Section 506 as enacted is virtually identical to section 506 as proposed by Rep. Boustany and Rep. Holding. As indicated by Rep. Boustany's November 19, 2013

[9] *See* H.R. Rep. No. 114-71, at 8 (2015) ("The Committee further found that still other groups simply organized under section 501(c)(4) without providing notice to the IRS, a practice that is currently permitted under the Code."). *See also* Doug Mancino, *Don't Eliminate 501(c)(4) Exemption*, N.Y. TIMES (May 15, 2013), *available at* http://www.nytimes.com/roomfordebate/2013/05/15/does-the-irs-scandal-prove-that-501c4s-should-be-eliminated/dont-eliminate-501c4-exemption (advocating disclosure requirements for section 501(c)(4) organizations to prevent pop-up (c)(4)s).

[10] As mentioned below, Notice 2016-09 has extended the due dates for filing the notification.

[11] Section 405(f) of the PATH Act.

[12] Section 6652(c)(4).

press release, the legislation arose out of "unfair partisan targeting" of section 501(c)(4) organizations by the IRS.[13]

According to Rep. Boustany's press release, the legislation "provides a checks and balances system to the actions of unelected Washington bureaucrats like ousted IRS official Lois Lerner. The abuse of American taxpayers by the IRS must be stopped and this legislation advances that goal." According to the legislative history of the March 2015 bill, section 506 would "eliminate the need for a section 501(c)(4) organization that desires written IRS acknowledgment of its exempt status to apply for a formal IRS determination by requiring all organizations organizing under the section to provide the IRS with notice of existence and requiring the IRS to provide timely acknowledgment of that notice."[14]

If the quotation was intended to imply that the IRS's written acknowledgment of the notice would be a determination of exempt status, then it does not reflect the statutory language, which provides otherwise. Section 506(c) requires only that the IRS acknowledge receipt of the notice; it does not require the IRS to acknowledge the exempt status of the organization submitting the notice. Indeed, section 506(f) provides that, in addition to filing the notice under section 506(a), an organization may request a determination that the organization is exempt under section 501(c)(4).

In Notice 2016-09,[15] the Department of the Treasury and the IRS announced their intention to issue temporary regulations under section 506 prescribing the manner in which organizations must notify the IRS of their intent to operate under section 501(c)(4). To provide adequate transition time for organizations to comply with the new procedures, the Treasury Department and the IRS extended the due date for submitting the section 506 notice until at least 60 days from the date the regulations are issued.

[13] *See* "Boustany Defends Taxpayers Against Unfair IRS Targeting" (Nov. 19, 2013), *available at* http://boustany.house.gov/113th-congress/boustany-defends-taxpayers-against-unfair-irs-targeting/ (last visited Feb. 11, 2016).

[14] H.R. Rep. No. 114-71, at 8 (2015).

[15] 2016-6 I.R.B. 306.

II. Organizations That Intend in Good Faith to Operate as Other Than Section 504(c)(4) Organizations

A tax-exempt organization may be described in more than one subsection of 501(c).[16] For example, many section 501(c)(3) organizations also qualify under section 501(c)(4). An organization that is described in section 501(c)(3) may have its section 501(c)(3) status applied retroactively to the date of its formation if it files an application for recognition of its tax-exempt status on IRS Form 1023 within 27 months after organization.[17] If an organization described in section 501(c)(3) fails to file for recognition of its section 501(c)(3) status within 27 months of its organization, it will not qualify as a section 501(c)(3) organization until it is recognized as such by the IRS (*i.e.*, prospectively only), but it may nonetheless be treated as a section 501(c)(4) organization, and therefore not subject to federal income tax, from the date of its organization (*i.e.*, retroactively) until the date it is recognized as a section 501(c)(3) organization.[18]

We do not believe that Congress meant to require an organization that intends in good faith to operate under a section of 501(c) other than section 501(c)(4) to file the section 506 notice, if the organization also is described in section 501(c)(4). The provision imposing penalties for failure to provide the notice describes section 506(a) as "relating to organizations required to notify [the] Secretary of *intent to operate* as [a] 501(c)(4)" organization [emphasis added].[19] Section 506(a) provides that an organization described in section 501(c)(4) must notify the Secretary "that it is operating as such." An organization that intends in good faith to operate under a different subsection of section 501(c) does not pose the risk of a pop-up 501(c)(4) that section 506 would prevent.

We also do not believe that Congress intended to require an organization that is described in section 501(c)(3), but that fails to file an IRS Form 1023 within 27 months of its organization and is therefore treated as a section 501(c)(4) organization until it receives its determination letter, to notify the IRS under section 506. Such an organization would not intend to operate as a section 501(c)(4) organization; it would intend to operate solely as a section 501(c)(3) organiza-

[16] *See, e.g.*, Rev. Rul. 80-108, 1980-1 C.B. 119 (describing an organization which "qualifies for exemption from federal income tax under both section 501(c)(3) and section 501(c)(4)"); *see also* Rev. Rul. 74-361, 1974-2 C.B. 159; Rev. Rul. 66-179, 1966-1 C.B. 139.

[17] Temp. Treas. Reg. § 1.508-1T(a)(2)(i) (request for exemption under section 501(c)(3) must be filed within 15 months of organization); Treasury regulations § 301.9100-2(a)(2)(iv) (automatic 12 month extension for application for section 501(c)(3) exemption).

[18] Rev. Rul. 80-108, 1980-1 C.B. 119.

[19] Section 6652(c)(4)(A).

tion, and as such, would be barred under its organizational documents or state law from engaging in political activity. Moreover, a charity that has failed to file its Form 1023 certainly will also have failed to notify the IRS under section 506, and so imposing section 506 penalties on it would amount to a double penalty (the inability to qualify under section 501(c)(3) retroactively to its date of organization and the monetary penalties under section 506).

However, an organization should be required to notify the IRS under section 506 if it does not in good faith intend to operate as other than a section 501(c)(4) organization or engages in activities that only a section 501(c)(4) organization could engage in (*e.g.*, it intends to engage or in fact engages in political activities, and it does not in good faith intend to qualify under another subsection of 501(c)).

III. Foreign Organizations

Foreign organizations may be described in many subsections of section 501(c), including section 501(c)(4).[20] In fact, because a section 501(c)(4) organization need not file for recognition of its tax-exempt status, many foreign not-for-profit organizations described in section 501(c)(4) may be unaware that they are so described, because they receive no benefit from their status. Foreign not-for-profit organizations formed for social welfare purposes that engage in substantial lobbying, in or outside the United States, likely are described in section 501(c)(4), and not in any other subsection of 501(c).[21] These organizations could file for recognition of their section 501(c)(4) status, but would suffer no adverse consequences for not filing.

Many foreign organizations satisfy the definition of a section 501(c)(4) organization but have no significant activities in the United States. However, if new section 506 applies to foreign organizations simply because they are described in section 501(c)(4) and without regard to their U.S. activities, all such organizations and their managers could be subject to U.S. tax penalties for failure to provide the section 506 notice.

[20] Certain subsections of section 501(c) are by their terms limited to domestic organizations. *See, e.g.*, section 501(c)(1) (describing certain corporations organized under an Act of Congress) and section 501(c)(10) (describing certain domestic fraternal societies, orders, or associations).

[21] No substantial part of the activities of a section 501(c)(3) organization may consist of carrying on lobbying. Because there is no bright line test as to the amount of lobbying activities that constitute a substantial part of an organization's activities, it is uncertain whether foreign organizations that engage in lobbying would qualify under section 501(c)(3). However, the distinction did not ordinarily matter prior to the enactment of the PATH Act because neither donors to foreign section 501(c)(3) organizations nor donors to section 501(c)(4) organizations are entitled to a charitable deduction for income tax purposes, and these organizations, insofar as they do not engage in activities within the United States, would not generally be subject to U.S. federal income tax, except possibly for withholding on certain investment income.

As discussed above, section 506 applies only to organizations that operate as section 501(c)(4) organizations and apparently was intended to apply to domestic organizations that experienced significant delays in securing IRS recognition of their exempt status or that operate as pop-up (c)(4)s. We believe that Congress intended the term "operate" to mean "operate as a section 501(c)(4) organization in the United States." Section 506(b) requires that the notice sent to the IRS include "the *State* under the laws of which, the organization was organized" [emphasis added]. This suggests that Congress had in mind only organizations located in the United States.[22] Under the Federal Election Campaign Act, foreign organizations are not permitted to solicit or receive contributions in connection with a federal, state, or local election, and therefore foreign organizations may not engage in political activities.[23] For these reasons, we believe that it would be entirely consistent with the statute and its apparent purpose for regulations to provide that foreign organizations are generally not required to file a notice under section 506.

However, such a rule could permit foreign organizations described in section 501(c)(4) to engage in nonpolitical activities, including lobbying, in the United States without being required to notify the IRS of their existence and therefore might provide for more favorable treatment of foreign organizations than domestic organizations, even though they might operate identically.

For this reason, we recommend that regulations provide that a foreign organization described in section 501(c)(4) is not required to file a notice under section 506 if it has no significant activities in the United States. Foreign organizations described in section 501(c)(4) that commence engaging in significant activities in the United States could be required to file the notice under section 506 within 60 days after those U.S. activities commence.

There are a number of ways to define "significant activities" for purposes of requiring a foreign organization described in section 501(c)(4) to file a notice under section 506. We believe

[22] "State" is defined in section 7701(a)(10) to include the District of Columbia. In the exempt organization context, the term "State" is used very precisely, as exemplified by the usage in section 170(c)(2) (recognizing a charitable contribution deduction for a gift to "*a State*, a possession of the United States, or any political subdivision of any of any of the foregoing, or the United States or the District of Columbia" or to a corporation "created or organized in the United States or in any possession thereof, or under the law of the United States, *any State*, the District of Columbia, or any possession of the United States") [emphasis added]. Section 6033(c)(2) requires a private foundation to furnish a copy of its Form 990-PF to "State officials." In that context, Treas. Reg. § 1.6033-3(d) provides that a foreign private foundation is not required to send copies of its Form 990-PF to State officers.

[23] 52 U.S.C. § 30121(a); 22 U.S.C. § 611(b). These provisions prohibit any partnership, association, corporation, organization or other combination of persons organized under the laws of or having its principal place of business in a foreign country from soliciting, accepting, or receiving a contribution or donation of money or other thing of value, or to make an express or implied promise to make a contribution or donation, in connection with a Federal, State, or local election.

that significant activities should include any lobbying or political activity described in regulations section 1.501(c)(3)-1(c)(3)(ii) or (iii), but should not include activities in the United States that could be conducted in unlimited amounts by a section 501(c)(3) organization. Thus, we believe that a foreign organization that is engaged in lobbying activity outside the United States should be able to engage in purely charitable activity in the United States without having to file a section 506 notice, so long as it does not engage in any lobbying or political activity in the United States. Significant activities should not include portfolio investment activities.[24] For example, ownership of a portfolio interest in a limited partnership or limited liability company for investment purposes should not constitute a significant activity, regardless of whether the partnership or limited liability company engages in a trade or business in the United States.

It is an open question whether significant activities should include the operation of an unrelated trade or business in the United States (other than in connection with a portfolio investment).[25] On the one hand, if significant activities do not include the operation of an unrelated trade or business, section 506 could have the effect of encouraging the donor of a U.S. business to organize a foreign section 501(c)(4) rather than a domestic one to receive the donation, in order to avoid the section 506 notice requirement. If the operation of an unrelated trade or business is treated as a significant activity that requires the filing of a notice under section 506, then a second question arises as to the ownership threshold that triggers the section 506 notice requirement. The threshold could be a controlling interest in a partnership or limited liability company (alone or combined with the interests of disqualified persons, as defined in section 4958(f)(1)), or it could be a lesser amount.

[24] We note the United States has a strong policy of encouraging foreign investment. *See* section 864(b)(2) (trading in securities or commodities is generally not treated as a trade or business within the United States); section 881(c) (no tax imposed on a foreign corporation's portfolio interest); and Treasury regulation section 1.1441-9 (foreign organization without an IRS determination letter permitted to claim exemption (or partial exemption, in the case of a private foundation) from withholding on dividends and other investment income by providing, along with IRS Form W-8EXP, an opinion of U.S. tax counsel concluding that the organization is described in section 501(c)); see also section 4948(b) (United States source investment income excluded in determining whether a foreign organization has received substantially all of its support from sources outside the United States).

[25] Including operation of a trade or business would conform the definition of significant activities of a foreign organization for section 506 purposes with the guidance contained in Rev. Proc. 2011-15, 2011 I.R.B. 322, § 3.02 for purposes of the return filing requirements under section 6033. Rev. Proc. 2011-15 describes certain exceptions to Form 990 filing obligations for certain foreign organizations that have "no significant activity (including lobbying and political activity and the operation of a trade or business, but excluding investment activity) in the United States."

On the other hand, the operation of an unrelated trade or business in the United States might not be viewed as a significant activity for this purpose under any circumstance. Section 506(a) requires an organization described in section 501(c)(4) to notify the IRS that "it is operating as such." The operation of an unrelated trade or business is not inherently a section 501(c)(4) activity the way lobbying or political activities are. Operating an unrelated trade or business could be viewed as akin to an investment activity which could be undertaken by any foreign organization, whether or not described in section 501(c)(4), and always requires tax return filings, albeit at a later date.[26]

It is also an open question whether a foreign organization described in section 501(c)(4) that conducts lobbying activity in the United States exclusively through personnel and agents located outside the United States should be treated as engaged in significant activities in the United States and required to file a section 506 notice. Treasury and the IRS may wish to address this question in regulations, although we believe that this situation will be rare.

Regardless of whether the operation of an unrelated business requires foreign section 501(c)(4) organizations to file the section 506 notice, our proposed rule would not require an organization described in section 501(c)(4) that has no significant activities in the United States to file a notice under section 506, even if the organization may be required to file an IRS Form 990.[27] We do not believe that Congress intended a foreign organization with no significant activities in the United States to be required to file a notice under section 506. These organizations have no meaningful active presence in the United States, are barred from political activity by the Federal Election Campaign Act, and do not pose the risk of a pop-up 501(c)(4) (or the lobbying equivalent); and there are likely many thousands of them. If these organizations were required to file the notice, there likely would be massive unintentional noncompliance with section 506 by foreign organizations described in section 501(c)(4).

[26] If this approach is accepted, consideration should be given to referring to "significant operations" rather than "significant activities" to distinguish the section 506 standard from the standard used in Rev. Proc. 2011-15.

[27] Section 6033 requires certain tax-exempt organizations to file annual returns. Under the most recent Revenue Procedure under section 6033, the IRS has provided an exemption from Form 990 filing requirements for a foreign organization exempt from federal income tax under section 501(a) because it is described in section 501(c) (other than a private foundation or a supporting organization) if it normally does not receive more than $50,000 in annual gross receipts from sources within the United States and has no significant activity (including lobbying and political activity and the operation of a trade or business, but excluding investment activity) in the United States. Rev. Proc. 2011-15, 2011 I.R.B. 322, § 3.02. The Revenue Procedure further provides that a foreign organization that is exempt from federal income tax under section 501(a) because it is described in section 501(c) and that is not required to file a return by virtue of section 3.02 of the Revenue Procedure must submit Form 990-N, the electronic notice (e-Postcard) return. Rev. Proc. 2011-15 § 3.03.

Very truly yours,

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