

DRAFT Memorandum – **Privileged & Confidential**

TO: David Knipel

FROM: Celia Roady

Kimberly Eney

DATE: January 16, 2013

SUBJECT: Standards for Group Exemption

You have asked us to describe the rules applicable to organizations seeking to qualify as a Section 501(c)(3)<sup>1</sup> organization under a central organization's group exemption. We understand that the American Baptist Churches in the U.S.A. ("ABCUSA") received a determination letter from the Internal Revenue Service ("IRS") recognizing group exemption under Section 501(c)(3) for ABCUSA, as the central organization, and a number of ABCUSA electing affiliates. ABCUSA has added electing affiliates to its group exemption since its receipt of the initial determination letter and would like to confirm the IRS requirements for adding affiliates. This memorandum describes the process for maintaining group exemption under Section 501(c)(3) and the considerations ABCUSA should make when evaluating whether to include an affiliate in its group exemption.

Background

**ABCUSA was formed in 1907 in the midst of a strong Baptist tradition emphasizing the need for autonomous congregations free from government interference or hierarchical polity. ABCUSA received an IRS determination letter recognizing its federal income tax exemption under Section 501(c)(3) on April 8, 1955. In 1979, ABCUSA requested an IRS determination letter that ABCUSA and 2,600 electing affiliated organizations qualified for group exemption under Section 501(c)(3). ABCUSA had received advice from the IRS indicating that the 1955 ruling was a "group ruling" that extended to ABCUSA's affiliates, "including its national boards, mission agencies, local churches, and regional, state and city societies," but submitted the request after receiving subsequent advice indicating that its 1955 ruling did not apply to ABCUSA affiliates.**

**In its request for group exemption, ABCUSA established that it served as the principal coordinating entity of the American Baptist denomination. ABCUSA also described conversations during which the**

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1 All Section references hereinafter made are to the Internal Revenue Code of 1986, as amended.

IRS recognized that ABCUSA and its affiliates met the requirements for group exemption in spite of its less hierarchical structure. For example, ABCUSA affiliates were not required to characterize their status as subordinates when providing written authorization for their inclusion in the group exemption, and ABCUSA's dissemination of nationally-adopted ecclesiastical and spiritual policies to the local churches and affiliates met the underlying standards for group exemption. The request included additional information contained in exhibits, such as a list of electing affiliated organizations, a discussion of the congregational structure of the American Baptist denomination, a statement describing the purposes and activities of ABCUSA and its electing affiliates, a copy of a sample governing instrument of an electing affiliate, and representative financial information for an electing affiliate that indicated the affiliate's sources of receipts and nature of expenditures. ABCUSA's records no longer contain these exhibits, and it would need to make a request to the IRS for a copy of its complete group exemption application in order to obtain such exhibits.

On June 28, 1979, the IRS issued a determination letter to ABCUSA indicating that ABCUSA and the electing affiliated organizations qualified for group exemption under Section 501(c)(3). The determination letter provides that the electing affiliates are organizations described in Section 509(a)(1) and 170(b)(1)(A)(i) (i.e., churches or conventions or associations of churches) and require ABCUSA to provide annual updates to the IRS. Since receipt of the IRS determination letter recognizing its group exemption, ABCUSA has added new affiliates, including organizations classified as churches or conventions or associations of churches and other types of organizations such as day care centers, youth camps, cemeteries, and computer centers. The process for including an organization under ABCUSA's group exemption has consisted of ensuring that the organization is in good standing and affiliated with ABCUSA and reviewing a copy of the organization's articles and bylaws for compliance with Section 501(c)(3).

#### Legal Discussion

In order to ease the administrative burden associated with processing exemption applications for certain affiliated organizations, the IRS will issue group exemption under Section 501(c)(3) to a central organization and its subordinates. A central organization must establish its own recognition for exemption under Section 501(c)(3) and demonstrate that the subordinates to be included under group exemption are: (1) affiliated with it; (2) subject to its "general supervision or control;" (3) exempt under the same paragraph of Section 501(c), although not necessarily the same paragraph as the central organization; (4) not a private foundation; and (5) all on the same accounting period as the central organization if they are to be included in a group return.<sup>2</sup> Subordinates must submit written authorization, signed by an officer, for the central organization to include it in the group exemption; new organizations must submit this authorization before the end of the 15th month after it was formed in order to be recognized as exempt as of the date of creation, and the central organization must include the subordinate in its next annual submission.<sup>3</sup>

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2 Rev. Proc. 80-27, §§ 4.01-4.02, 1980-1 C.B. 677.

3 Rev. Proc. 80-27, §§ 4.03, 1980-1 C.B. 677.

The IRS has not defined what it means for a subordinate to be subject to a central organization's "general supervision or control," but it is currently in the process of reviewing the standards for group exemption and may issue guidance on this definition over the next few years. In 2011, the Advisory Committee on Tax Exempt and Government Entities ("ACT") released a report analyzing the group exemption process and recommending updated guidance on the meaning of "general supervision or control."<sup>4</sup> The IRS followed this report in 2012 by issuing a compliance survey asking selected group ruling holders a number of questions regarding their relationship with subordinates, including possible indicia of "general supervision and control," and it is likely that these surveys will help form the basis of any future IRS guidance on the definition.<sup>5</sup>

A central organization that obtains group exemption for its subordinates is responsible for ensuring that its subordinates continue to qualify as exempt under Section 501(c)(3) and verifying that new subordinates qualify for group exemption. It must provide an annual update to the IRS, notifying the IRS of any changes to the purpose, character, or operations of subordinates; new subordinates to be included in the group exemption; subordinates that should no longer be included in the group exemption; and any changes to the name or address of subordinates.<sup>6</sup> If the information about new subordinates does not materially resemble the information contained in the initial application for group exemption, the request for inclusion of new subordinates must contain the same information required for an initial application, such as verification of the "general supervision or control" relationship, a sample copy of a uniform governing instrument adopted by the subordinates, and a detailed description of the purposes and activities of the subordinates, including the sources of receipts and the nature of expenditures.<sup>7</sup>

Finally, inclusion under a central organization's group exemption does not relieve a subordinate organization from the Form 990 filing requirements applicable to Section 501(c)(3) organizations under Section 6033(a). Most Section 501(c)(3) organizations are required to file a version of the Form 990, although churches, their integrated auxiliaries, and conventions or associations of churches are exempt from this requirement.<sup>8</sup> Central organizations can file a group return on behalf of some or all of their

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4 Advisory Committee on Tax Exempt and Government Entities, "Exempt Organizations: Group Exemptions – Creating a Higher Degree of Transparency, Accountability, and Responsibility," June 15, 2011, *available at*: [http://www.irs.gov/pub/irs-tege/ACT\\_Group\\_Ruling\\_Rpt\\_061511.pdf](http://www.irs.gov/pub/irs-tege/ACT_Group_Ruling_Rpt_061511.pdf).

5 *See* <http://www.irs.gov/pub/irs-tege/F14414.pdf>.

6 Rev. Proc. 80-27, § 6.01, 1980-1 C.B. 677.

7 Rev. Proc. 80-27, § 6.01(3), 1980-1 C.B. 677.

8 I.R.C. § 6033(a)(3)(A)(i).

subordinates, but if a subordinate is not included in a group return then it is responsible for adhering to the Form 990 filing requirements. Organizations that fail to file a return for three years automatically lose their tax-exempt status.<sup>9</sup>

## Analysis

ABCUSA is in the process of evaluating its standards for including an affiliated organization in its group exemption. As a first step, ABCUSA should review the 1979 application that it submitted to request group exemption and identify the types of organizations that qualified as affiliates at that time and the means by which ABCUSA exercised “general supervision or control” over these organizations. It would be helpful to obtain the exhibits included with the application for greater clarity, and we recommend that ABCUSA request a copy of its complete application for group exemption with the IRS. In the meantime, it is clear that the initial electing affiliates all qualified as churches or conventions or associations of churches and that ABCUSA exercised “general supervision or control” in spite of the absence of a true hierarchical structure. As a result, ABCUSA can continue to include ABCUSA organizations that qualify as churches or conventions or associations of churches in its group exemption.

ABCUSA also receives requests for inclusion in its group exemption from organizations that are related to ABCUSA but are not classified as churches or conventions or associations of churches. For example, some organizations included in ABCUSA’s group exemption are described as day care centers, youth camps, cemeteries, and computer centers. ABCUSA should exercise caution when choosing to include these organizations in its group exemption. Although it is possible that additional information obtained after reviewing the complete group exemption application will indicate that these organizations resemble certain initial electing affiliates, the IRS determination letter regarding ABCUSA’s group exemption does not so clearly apply to these organizations as they are not classified as churches or conventions or associations of churches and therefore may not have the same type of “general supervision or control” relationship described in the initial application.

Before adding ABCUSA organizations in good standing that are not classified as churches or conventions or associations of churches to its group exemption, ABCUSA should ensure that these organizations qualify as Section 501(c)(3) organizations, would not be classified as private foundations, and are subject to ABCUSA’s “general supervision or control.” To do this, ABCUSA should request a description of the organization’s activities in addition to copies of the articles and bylaws and review these materials to ensure compliance with Section 501(c)(3) standards. ABCUSA should also request a copy of the organization’s anticipated budget, if it is a new organization, or a copy of its financial statements showing the sources of receipts and the nature of expenditures to confirm that the organization would not be classified as a private foundation. ABCUSA should also ensure that it receives written authorization,

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9 I.R.C. § 6033(j)(1).

signed by an officer, from the electing affiliate to include the organization in ABCUSA's group exemption. If ABCUSA approves the request for inclusion in its group exemption, then it should monitor these electing affiliates' activities on an ongoing basis by requiring them to provide ABCUSA with a copy of their financial statements, Form 990 (if applicable), and any changes to their governing documents each year. ABCUSA should notify current electing affiliates (that are not classified as churches or conventions or associations of churches) of these new requirements and request any information it may need to complete its records, such as copies of the organization's articles and bylaws or written authorization. ABCUSA can serve as a fiscal sponsor for organizations that choose not to comply with these requirements until they obtain Section 501(c)(3) status independently.

Because there is no concrete definition, it is possible that ABCUSA's requirements for inclusion in its group exemption and its ongoing monitoring process would constitute "general supervision or control." However, it is anticipated that the IRS will issue guidance on the definition of "general supervision or control" over the next few years, and ABCUSA should be prepared to change its practices to ensure compliance with any new standards.

Finally, ABCUSA should remind its electing affiliates of the need to file the Form 990 with the IRS unless an exception, such as classification as an integrated auxiliary, applies.

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Dave, this memorandum summarizes the process for organizations to maintain group exemption under Section 501(c)(3) and describes some steps ABCUSA can take when choosing to add an electing affiliate to its group exemption. As a first step, we recommend that ABCUSA request a complete copy of its application for group exemption in order to gain some clarity about the types of organizations that initially qualified as electing affiliates under its group exemption and the nature of ABCUSA's "general supervision or control" over these organizations. In the meantime, it seems consistent with ABCUSA's group exemption application to continue to include organizations that are classified as churches and conventions or associations of churches in its group exemption. It is less clear that other types of organizations, such as day care centers, camps, cemeteries, and computer centers, are consistent with the electing affiliates described in the initial application. Unless ABCUSA subsequently learns that these organizations resemble the initial electing affiliates, ABCUSA should ensure that these organizations qualify as Section 501(c)(3) organizations, are not private foundations, and are subject to ABCUSA's "general supervision or control" prior to including them in ABCUSA's group exemption. As noted, we recommend that ABCUSA review the articles, bylaws, a description of activities, and financial information of electing affiliates to ensure that each organization is in compliance with Section 501(c)(3) standards and would not be classified as a private foundation. ABCUSA should then monitor these organizations on

an ongoing basis by requiring them to provide copies of financial statements, the Form 990 (if applicable), and any changes to the governing documents to ABCUSA each year. ABCUSA should notify any electing affiliates (that are not classified as churches or conventions or associations of churches) of these new requirements, and it can offer to serve as a fiscal sponsor for organizations that do not want to comply. ABCUSA should also remind electing affiliates of the possible need to file the Form 990 each year with the IRS.

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IRS Circular 230 Disclosure

To ensure compliance with requirements imposed by the IRS, we inform you that any U.S. federal tax advice contained in this communication (including any attachments) is not intended to be written or used, and cannot be used, for the purpose of (i) avoiding penalties under the Internal Revenue Code or (ii) promoting, marketing or recommending to another party any transaction or matter addressed herein.

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