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RESOLVING A SMALL MISTAKE THAT HAS BIG POTENTIAL CONSEQUENCES

BRENT FELLER AND CHRISTIE GALINSKI

There is no official procedure by which a private school can cure a failure to file the annual certification of racial nondiscrimination.

Form 5578 is a half-page form simply certifying that a private school has complied with the racial nondiscrimination guidelines set forth by the Service.¹ The failure of a private school to annually file this form may jeopardize the school's tax-exempt status under Section 501(c)(3).² To complicate the issue, there is no official procedure set out for a private school to cure this failure to file, though the private school may resolve the issue through a closing agreement with the Service.

Background

The obligation for schools that are tax-exempt under Section 501(c)(3) to have a nondiscrimination policy grew out of the civil rights movement. The U.S. Supreme Court held in *Brown v. Board of Education* that racial discrimination in public schools was illegal and contrary to public policy.³ This holding spurred efforts by some to establish private schools (known as "segregation academies") to oppose public school desegregation.⁴ In 1967, the Service took a first step in response to those efforts and announced that racially discrim-

inatory private schools that were receiving state aid were not entitled to exemption under Section 501(c)(3), based on public policy.⁵

Prior to 1970, the Service allowed private schools with racially discriminatory policies to retain their exempt status as long as they did not receive state aid. Its position was that the public policy against private discrimination was not as clearly defined as the policy against public discrimination. In 1970, however, parents of African-American children attending public schools in Mississippi brought suit to prevent the Service from recognizing exemption for private schools in Mississippi that discriminated on the basis of race.⁶ The district court held (and the Supreme Court affirmed) that racially discriminatory private schools are not entitled to exemption and that people making gifts to such schools are not entitled to charitable deductions. This holding applies to schools in every state. The district court also placed the Service under a permanent injunction to deny tax exemption to private schools in Mississippi that practice racial discrimination and ordered the Service to implement the court's decision by requiring those schools to adopt and publish a specific nondiscriminatory policy and to provide certain information so that the Service could determine if the schools

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are racially discriminatory. The injunction applies only to Mississippi schools.

While the issues in the Mississippi case were being litigated, the Service announced that racially discriminatory private schools (located in any state) are not entitled to tax exemption regardless of whether or not they receive state aid.⁷ In Rev. Proc. 75-50,⁸ the Service established the guidelines described below (including the annual certification requirement) and record-keeping requirements for determining whether private schools that are applying for exemption under Section 501(c)(3) have a racial nondiscrimination policy as to students. The revenue procedure also applies to private schools that wish to retain federal tax exemption.

The certification requirement

The nondiscrimination guidelines laid out in Rev. Proc. 75-50 are still in effect today. A school that does not have a racial nondiscrimination policy regarding its students does not qualify as an organization exempt from federal tax.⁹ A racial nondiscrimination student policy "means that the school admits students of any race to all the rights, privileges, programs, and activities generally accorded or made available to students at that school and that the school does not discriminate on the basis of race in the administration of its educational policies, admissions policies, scholarship and loan programs, and athletic and other school-administered programs."¹⁰

Rev. Proc. 75-50 lays out specific guidelines for nondiscrimination policies to ensure a uniform approach to be used in determining whether private schools have a racial nondiscrimination policy as to students.¹¹ The guidelines include an annual certification requirement, which a school could easily overlook. Even if a school complies with all the other

guidelines of a racial nondiscrimination policy, its exempt status is still threatened if it does not comply with the annual certification requirement.

The annual certification requirement requires a private school to annually certify that it has met all the requirements of the guidelines in Rev. Proc. 75-50.¹² The certification must be provided by an individual authorized to take official action on behalf of a school. Such person must certify under penalties of perjury that, to the best of his or her knowledge and belief, the school has satisfied the applicable guidelines of the revenue procedure, as listed below.

Forms 990¹³ or 990-EZ¹⁴ provide the annual racial nondiscrimination certification on Schedule E, line 7.¹⁵ However, a private school (below college level) that has a program of a general academic nature, and that is affiliated with a church or operated by a religious order, is one type of entity that is not required to file Form 990.¹⁶ Even if a school is not required to file a Form 990, it must make an annual certification confirming its compliance with the guidance concerning racial nondiscrimination student policies on Form 5578.¹⁷

Nondiscrimination guidelines for private schools

The nondiscrimination certification is a certification that the guidelines for a nondiscrimination policy from Rev. Rul. 75-50 have been met. Those requirements may be summarized as follows.

1. A private school must include a statement in its governing instrument (e.g. its charter or by-laws), or in a resolution of its governing body, that it has a racial nondiscrimination policy as to students and therefore does not discriminate

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¹ Form 5578, "Annual Certification of Racial Nondiscrimination for a Private School Exempt from Federal Income Tax."

² Rev. Proc. 75-50, 1975-2 CB 587, section 4.06.

³ 347 U.S. 483 (1954).

⁴ "Private Schools," *Exempt Organizations Continuing Professional Education Technical Instruction Program for FY 1989* (1979).

⁵ *Id.*

⁶ *Green v. Connally*, 330 F. Supp. 1150, 28 AFTR2d 71-5164 (DC Col., 1971), *affd. per cur. sub nom. Coit v. Green*, 404 U.S. 997, 29 AFTR2d 72-370 (1971).

⁷ Rev. Rul. 71-447, 1971-2 CB 230.

⁸ 1975-2 CB 587.

⁹ Rev. Rul. 71-447, 1971-CB 230; *Bob Jones University v. Simon*, 461 U.S. 574, 33 AFTR2d 74-1279 (1974).

¹⁰ Rev. Rul. 71-447, *supra* note 7; Rev. Proc. 75-50, *supra* note 8 at section 3.01.

¹¹ Rev. Proc. 75-50, *supra* note 8 at section 2.03.

¹² Rev. Proc. 75-50, *supra* note 8 at section 4.06.

¹³ Form 990, "Return of Organization Exempt from Income Tax."

¹⁴ Form 990-EZ, "Short Form Return of Organization Exempt from Income Tax."

¹⁵ Section 6033(a); Reg. 1.6033-2(a)(1). Organizations with gross receipts over \$200,000 or total assets over \$500,000 must generally file a Form 990, while organizations below those thresholds may file the shorter Form 990-EZ. News Release 2007-204 (12/20/07). Organizations whose annual gross receipts are normally \$50,000 or less may choose to electronically submit Form 990-N unless they choose to file a complete Form 990 or 990-EZ. Reg. 1.6033-6(a).

¹⁶ Reg. 1.6033-6(b)(2)(iv).

¹⁷ Ann. 76-143, 1976-47 IRB 19.

against applicants and students on the basis of race, color, or national or ethnic origin.¹⁸

2. A private school must also include a statement of its racial nondiscrimination policy as to students in all its brochures and catalogues that deal with student admissions, programs and scholarships.¹⁹ The revenue procedure provides sample language.
3. A private school must include a reference to its policy in other written advertising that it uses as a means of informing prospective students of its programs. The revenue procedure provides sample language.
4. A private school must either publish a notice of its racial nondiscrimination policy in a newspaper of general circulation or use broadcast media to publicize its racial nondiscrimination policy.²⁰ The revenue procedure provides an example and specific requirements for the size and content of the newspaper announcement. If the school uses the option to announce its nondiscrimination policy using broadcast media, it must comply with specific regulations in addition to certain recordkeeping requirements.
5. A private school must also be able to show that all of its programs, facilities, and scholarships are operated in a racially nondiscriminatory manner.²¹

The fourth requirement above (the publicity requirement) may be satisfied by alternative means if the school is a religious school, has a geographically diverse student body, or customarily draws its students from local communities.²² Notwithstanding the alternative publicity methods, the Service encourages schools to satisfy the publicity requirement using the general rules because it believes these methods to be the most effective way to publicize a school's policy.

The alternative method for religious schools applies to parochial or other church-related schools if at least 75% of the enrollees are mem-

bers of the sponsoring religious denomination or unit. In these circumstances, the school may make known its racial nondiscrimination student policy in whatever newspapers or circulars the religious denomination or unit utilizes in the communities from which the students are drawn. The newspaper or circular may be one distributed by a particular religious denomination or unit, or by an association that represents a number of religious organizations of same denomination. However, if the religious school advertises in a newspaper of general circulation (and the special rules for the second and third alternatives do not apply), the school must comply with the publicity requirements of the general rules for a newspaper announcement.²³

Confusion regarding religious schools

Religious schools, although subject to some special rules, still must generally comply with the nondiscrimination guidelines of Rev. Proc. 75-50. Fortunately, a school that selects students on the basis of membership in a religious denomination or unit thereof will not be deemed to have a discriminatory policy if membership in the denomination or unit is open to all on a racially nondiscriminatory basis.²⁴

Notwithstanding the fact that religious schools will not automatically be deemed to be discriminatory, the Service has ruled that private schools must maintain a racial nondiscrimination policy, whether they are incorporated separately from a sponsoring church or directly supervised and controlled within the same organization as a church.²⁵ Furthermore, in GCM 37033,²⁶ the Service specifically ruled that the regulations provide sufficient authority for requiring church-related schools that do not have a separate legal existence apart from a church to file the annual racial nondiscrimination certification required by Rev. Proc. 75-

¹⁸ Rev. Proc. 75-50, *supra* note 8 at section 4.01.

¹⁹ Rev. Proc. 75-50, *supra* note 8 at section 4.02.

²⁰ Rev. Proc. 75-50, *supra* note 8 at section 4.03(1).

²¹ Rev. Proc. 75-50, *supra* note 8 at section 4.04.

²² Rev. Proc. 75-50, *supra* note 8 at section 4.03(2).

²³ *Id.*

²⁴ Rev. Proc. 75-50, *supra* note 8 at section 3.03.

²⁵ Rev. Rul. 75-231, 1975-1 CB 158.

²⁶ 3/4/77.

²⁷ GCM 37033, 3/4/77.

²⁸ Rev. Proc. 75-50, *supra* note 8 at section 4.08. Rev. Proc. 75-50 states that the proposed revocation of exempt status

should be in accordance with the procedure in Rev. Proc. 72-4, 1972-1 CB 706, which is currently superseded by Rev. Proc. 2015-9, 2015-2 IRB 249, a revenue procedure that is updated annually.

²⁹ Rev. Proc. 2015-9, *supra* note 28.

³⁰ *Automobile Club of Michigan*, 353 U.S. 180, 50 AFTR 1967 (1957).

³¹ Rev. Proc. 2015-9, *supra* note 27 at section 12.01; Reg. 601.201(n)(6)(i).

³² 85 TC 743 (1985), *affd* 799 F.2d 903, 58 AFTR2d 86-5620 (CA-4, 1986).

³³ *Id.*

³⁴ Reg. 601.201(n)(6)(i).

50.²⁷ The nondiscrimination policy requirements that a religious school must comply with are the same as those for any other school, except that the religious school may publicize its policy in a local newspaper or circular used by the religious denomination in the communities from which the students are drawn, rather than a newspaper of general circulation.

Cure for failure to file Form 5578

A religiously affiliated private school may be surprised to discover the requirement to annually file a Form 5578. A private school may discover its failure to file Form 5578 at a particularly inopportune time. For example, if the private school is seeking a legal opinion regarding its Section 501(c)(3) status, it may not be able to obtain such an opinion if it has not complied with its annual certification requirements. A failure to annually certify can therefore have serious consequences, including the retroactive loss of a school's 501(c)(3) status.

As stated above, Rev. Proc. 75-50 provides that failure to comply with its guidelines will ordinarily result in the proposed revocation of the exempt status of a school in accordance with the general procedures for revoking an entity's exempt status.²⁸ These general procedures provide that the Service must first issue a notice of proposed revocation giving the organization an opportunity to appeal within 30 days.²⁹ To appeal, the taxpayer must submit a statement of the facts, law, and arguments in support of its position within 30 days from the date of the proposed adverse determination letter. Depending on the results of its review, the Service will then decide to issue either a final adverse determination letter or a favorable exempt status determination letter.

Not only does the revenue procedure allow the Service to propose a revocation of tax-exempt status for failure to certify compliance with the guidance on racial nondiscrimination policies, but the revocation can also be retroactive. Generally, Section 7805(b)(8) allows the Service broad discretion to make a ruling applicable without retroactive effect. The U.S. Supreme Court has stated that this Code section confirms the authority of the Commissioner to correct any ruling, regulation, or Treasury decision retroactively, but also empowered the Commissioner, in his or her discretion, to limit retroactive application to the extent necessary to avoid inequitable results.³⁰

The regulations provide three examples of situations in which a revocation of tax-exempt status could be retroactive. They involve the organization (1) omitting or misstating a material fact, (2) operating in a manner materially different from that originally represented, or (3) engaging in certain prohibited transactions.³¹ In *Virginia Education Fund*,³² the taxpayer claimed that revocation could only be retroactive if one of the three conditions was present, but the Tax Court and the Fourth Circuit disagreed. In that case, the Tax Court upheld the retroactive revocation of tax-exempt status for an organization that raised funds for donations to segregated schools when such organization did not meet its burden of establishing that the schools had adopted racial nondiscrimination policies and that the schools were operating in good faith in accordance with such policies.³³ On the other hand, the regulations also state that a revocation "will *ordinarily* take effect no later than the time at which the organization received written notice that its exemption ruling" might be revoked (emphasis added).³⁴ Nevertheless, the regulations do not exclude the possibility of the retroactive effect of a revocation of a determination letter under these circumstances. Accordingly, even if a school discovers its failure to file and begins to file Form 5578, doing so may not provide certainty that it has been continuously tax exempt.

Another issue that may cause substantial uncertainty is the rule under Section 6033(j), which allows the Service to automatically revoke tax-exempt status after an exempt taxpayer fails to file Form 990 for three consecutive years. The wording of Section 6033(j) is broad and may also encompass the failure to file Form 5578. In particular, Section 6033(j) states that revocation automatically occurs when the taxpayer fails to file an annual return or notice required under Section 6033(a)(1) or Section 6033(i). Section 6033(a)(1) not only requires the taxpayer to file an annual return stating its income, receipts, and disbursements (Form 990), but also requires the taxpayer to "make such other returns, and comply with such rules and regulations as the Secretary may from time to time prescribe." Thus, although unlikely, it is possible for the Service to apply the automatic revocation in cases of failure to file Form 5578.

There is no procedure outlined in the Code, regulations, or other guidance from the Service to cure a failure to file Form 5578. When there

is no prescribed procedure to request relief in a particular situation, the Service may agree to close an open issue using a closing agreement.³⁵ The Service has broad discretion under the Code to enter into a closing agreement. It may do so with "any person" relating to the liability of that person for "any internal revenue tax" for "any taxable period."³⁶ The regulations also specify that the Service may enter into a closing agreement if there appears to be an advantage in having the case permanently and conclusively closed, or if good and sufficient reasons are shown by the taxpayer for desiring a closing agreement.³⁷ Also, the Commissioner should determine that the United States would sustain no disadvantage from the agreement.³⁸

It should be noted, however, that the Service may not acquiesce to a closing agreement if the school's noncompliance goes beyond mere failure to file the form.

The Service has entered into such closing agreements, agreeing to not revoke the tax-exempt status of a private school based on the school's past failure to file Form 5578. The Service's willingness to enter into these agreements seems to be an acknowledgment that the failure to file causes uncertainty regarding the private school's tax exemption and that the closing agreement is an acceptable method to resolve the issue.

Due to multiple layers of review within the exempt organization group at the Service, the closing agreement process may take up to three or four months from the time a first draft closing agreement is submitted to the Service. Thus, a school may wish to start the closing

agreement process as soon as the failure to annually certify is discovered. In past closing agreements, the Service has not charged a fee or imposed a penalty for the closing agreement. According to the Service's procedures, the school should mail a request letter, along with a proposed closing agreement, to the exempt organization division.³⁹ In the request letter, the school should set out a statement of facts and analysis with the other information required by the instructions. In the closing agreement, the school should agree to file Forms 5578 for six prior years and declare its intention to file annually in future years, while the Service may generally agree to not revoke the tax-exempt status of the school based on the historical failure to file Form 5578.

Please note that the closing agreement process for failure to file a Form 5578, as described above, is separate from the process for reinstatement of automatic revocation of tax-exempt status for the failure to file Form 990 for three consecutive years. The process to reinstate tax-exempt status for failure to file Form 990 is governed by Rev. Proc. 2014-11 and requires a fee (currently between \$400 and \$850, depending on average annual gross receipts).⁴⁰ The required process depends on the size of the organization and how long after revocation the reinstatement is requested. Generally, for this resolution, the entity must resubmit Form 1023.⁴¹ If a school failed to fulfill its requirement to file Form 990 and uses the reinstatement process, the school would not need a closing agreement for the failure to file Form 5578 because the racial nondiscrimination certification is already provided on Form 990.

Conclusion

Since the failure to file a Form 5578 authorizes the Service to propose a revocation of the school's tax-exempt status, a school may desire assurance from the Service that it will not revoke such status based on this failure to file. Because there is no official procedure to receive this assurance, a school in this position may be well advised to pursue a closing agreement. ■

³⁵ Section 7121.

³⁶ *Id.*

³⁷ Reg. 301.7121-1.

³⁸ *Id.*

³⁹ The Service describes the requirements and procedure to request a closing agreement with the exempt organization group in IRM 4.75.25, in Rev. Proc. 2015-4, 2015-1 IRB 144, and on its Web site at www.irs.gov/Charities-&-Non-Profits/Contributors/Charity-and-Nonprofit-Audits:-Closing-Agreements (current as of 5/11/15).

⁴⁰ Rev. Proc. 2014-11, 2014-3 IRB 411; Rev. Proc. 2013-8, 2013-1 IRB 237.

⁴¹ Form 1023, "Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code."