

BILL ANALYSIS

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Department, Board, Or Commission	Author	Bill Number
Franchise Tax Board	Eng	AB 404

SUBJECT

Exempt Organizations/Subordinate Organizations Included In Federal Group Exemption Letter

SUMMARY

This bill would do the following:

- eliminate the requirements for certain tax exempt entities that are granted federal group exemption to apply separately for state tax exemption, and
- allow the Franchise Tax Board (FTB) to permit inspection of certain exemption documents.

PURPOSE OF BILL

According to the author's office, this bill would provide administrative convenience for both FTB and for organizations that are exempt under federal law by further streamlining the State tax exemption process for an organization with many affiliated organizations.

EFFECTIVE/OPERATIVE DATE

This bill would become effective and operative January 1, 2010.

ANALYSIS

FEDERAL/STATE LAW

Federal law

Internal Revenue Code (IRC) Section 501(c)(3) Organizations

Under the IRC, certain entities are treated as tax-exempt organizations. A tax-exempt organization can be a trust, unincorporated association, or nonprofit corporation.

The terms "nonprofit" and "tax-exempt" have different meanings. Nonprofit status is a matter of State law, which governs the organization and creation of the entity. All tax-exempt organizations are nonprofit, but not all nonprofits are tax-exempt.

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Tax-exempt status is conferred for purposes of exemption from income tax. Section 501(c)(3) organizations make up the largest category of tax-exempt entities. They are organized and operated for one or more of the following purposes:

1. Charitable
2. Educational
3. Religious
4. Scientific
5. Literary
6. Testing for public safety
7. Fostering national or international amateur sports competition
8. Preventing cruelty to children or animals

To qualify for exempt status with the IRS, a 501(c)(3) organization must be organized under state law as a corporation, community chest, fund, or foundation. Churches, conventions, or associations of churches, and any organization (other than a private foundation) normally having annual gross receipts of less than \$5,000 annually, are exempt automatically if they meet the exempt purpose requirements of IRC section 501(c)(3). Organizations that are not automatically exempt must apply for tax-exempt status showing that all of the following are true:

- The organization is organized exclusively for, and will be operated exclusively for, one or more of the purposes (e.g., charitable, religious) specified above.
- The organization's net earnings in no part inure to the benefit of private shareholders or individuals.
- The organization will not, as a substantial part of its activities, attempt to influence legislation (unless it elects to come under the provisions allowing certain lobbying expenditures) or participate to any extent in a political campaign for or against any candidate for public office.

Tax-Exempt Application

The IRS requires all applications for tax-exempt status to be accompanied with a copy of the organization's Articles of Incorporation or other document creating the organization. The Articles of Incorporation must limit the organization's purposes to one or more of the exempt purposes listed in IRC section 501(c)(3) and declares the assets of an organization permanently dedicated for its exempt use.

The application must include a full description of the proposed activities and a description of anticipated receipts and contemplated expenditures. The IRS also requires that copies of financial statements be submitted with the application.

Federal law requires the payment of a user fee when making a request for determination of exempt status. For organizations with annual gross receipts in excess of \$10,000 over 4 years, the fee is \$750; for those with annual gross receipts of less than \$10,000, the fee is \$300.

A ruling or determination letter will be issued to the organization if its application and supporting documents establish that it meets the particular requirements of the IRC section under which it is claiming exemption.

Federal Group Exemption

The IRS may recognize a group of organizations as tax-exempt if they are closely affiliated with a central or parent organization. This avoids the need for each of the organizations to apply for exemption individually.

Groups of organizations have a “head” or main organization, referred to as a central organization. The central organization generally supervises or controls many chapters, called subordinate organizations.

To qualify for a group exemption:

- the central organization and its subordinates must be affiliated, such that the central organization exercises supervision or control over the subordinate entities,
- the central organization must qualify for exemption under IRC section 501(c); and
- the subordinates must be exempt under the same paragraph of IRC section 501(c), but not necessarily the same as the central organization.

A group exemption letter is a ruling or determination that is issued to a central organization which holds that one or more subordinate organizations are exempt from federal income tax by virtue of being subordinate organizations of a central organization.

State Law

Tax-Exempt Application

Although most California laws dealing with tax exemptions are patterned after the IRC, obtaining state tax exemption is a separate process from obtaining federal exemption. Generally, in order to obtain state exemption from tax, an organization must: (1) submit a completed exemption application form to the Franchise Tax Board (FTB), (2) pay a filing fee of \$25, and (3) receive a letter issued by FTB indicating the organization is exempt from tax. The exemption application must include copies of the Articles of Incorporation, the by-laws of the organization, and financial statements showing assets, liabilities, receipts, and disbursements.

The tax-exemption requirements for California are the same as those listed in the federal law section of this analysis except that churches and small charities are not automatically exempt under state law; they must apply for state tax exemption.

Not all organizations seeking state tax exemption are required to file an application. Charitable organizations that are granted IRC section 501(c)(3) tax-exemption recognition are automatically granted state tax-exempt status following submission of its IRS determination letter.

State Group Exemption

The California group exemption process is independent from the federal law and procedures; however, with respect to the qualification for a central organization and its subordinates, California applies similar requirements as federal (see federal law section above).

For California purposes, a central organization seeking a group exemption letter for its subordinates must establish its own exemption separately by filing an exemption application form. The organization must then file a separate application requesting a group exemption with a letter stating that the subordinates are affiliated and are subject to the parent's general supervision and control. The central organization must include:

- a sample copy of a uniform charter for its subordinates,
- an affirmation that the subordinates are operating in accordance with their stated purposes,
- a statement that the subordinates have furnished written authorization to be included with the group exemption application; and,
- a list of California subordinates, their organization numbers (if applicable), and current addresses.

The organization applying for group exemption must also establish that the subordinates proposed to be included in the group application are exempt under the same lettered section of Revenue and Taxation Code section 23701, although not necessarily exempt under the same lettered section as the national, state or parent (central) organization.

THIS BILL

This bill would allow IRC section 501(c)(3) organizations granted federal tax-exemption on the basis of a federal group exemption to be tax-exempt for state purposes. It would require both the central organization and its subordinates covered by a federal group exemption to be tax-exempt under IRC section 501(c)(3).

This bill would specify that once FTB receives the federal determination ruling or a federal group exemptions letter, FTB would issue an acknowledgment letter recognizing the organization's state tax exemption status.

In addition, this bill would permit the following documents to be subject to public inspection:

- the documents submitted to FTB to verify an organization's federal tax exemption under IRC section 501(c)(3).
- the acknowledgment letters or other documents issued by FTB to acknowledge submission of the federal determination letter under IRC section 501(c)(3).

This bill would provide that a revocation of an organization's state tax exemption can only be reinstated upon compliance with Revenue and Taxation Code (R&TC) section 23701, regardless of whether the organization can establish federal exemption.

Under this bill, if a central organization's exemption status is withdrawn or revoked, all of the status for all of the supporting or affiliated group members would immediately be revoked and can be reinstated only upon compliance with R&TC section 23701.

LEGISLATIVE HISTORY

AB 897 (Stats. 2007, Ch. 238) eliminated the state requirement for filing a separate application process for certain organizations that receive federal tax-exempt recognition. The organization seeking tax exemption must, however, submit to the FTB its IRS determination letter and be an organization described under IRC section 501(c)(3).

OTHER STATES' INFORMATION

The states surveyed include *Florida, Illinois, Massachusetts, Michigan, Minnesota, and New York*. These states were selected due to their similarities to California's economy, business entity types, and tax laws.

The income tax regulations for *Florida, Illinois, Massachusetts, Michigan, Minnesota, and New York* provide a presumption that a corporation exempt from tax under federal law will also be exempt from their state income tax.

FISCAL IMPACT

This bill would not significantly impact the department's costs.

ECONOMIC IMPACT

Revenue Estimate

This bill would result in loss of processing fees of less than \$100 per year.

Revenue Discussion

The revenue impact of the bill would be determined by the number of parent and subordinate organizations that apply together to have income tax-exempt status for California and avoid paying a \$10 processing fee for each subordinate organization. Generally, a parent organization will file and include their subordinate organizations' income in its tax return. Therefore, the revenue impact is expected to be insignificant.

Appointments

None.

Support/Opposition

Support: Nonprofit & Unincorporated Organizations Committee of the Business Law Section of the State Bar of California

Opposition: None

VOTES

Assembly Floor – Ayes: 77, Noes: 0

Senate Floor – Ayes: 8, Noes:

LEGISLATIVE STAFF CONTACT

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