

## Franchise Tax Board

## ANALYSIS OF ORIGINAL BILL

Author: Rodriguez Analyst: Jon Feenstra Bill Number: AB 94  
Related Bills: See Legislative History Telephone: 845-4870 Introduced Date: January 10, 2017  
Attorney: Bruce Langston Sponsor: \_\_\_\_\_

**SUBJECT:** Exempt Organizations/Simplify Application Method for Federally Tax-Exempt Veterans' Organizations

### SUMMARY

This bill would modify the requirements for federally tax-exempt veterans' organizations to apply for a California income and franchise tax exemption.

### RECOMMENDATION – NO POSITION

### REASON FOR THE BILL

The reason for this bill is to allow an additional category of federally tax-exempt organizations to use the simplified process of applying for state tax-exempt status.

### EFFECTIVE/OPERATIVE DATE

This bill would be effective January 1, 2018, and operative as of that date.

### FEDERAL LAW

Under the Internal Revenue Code (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.

Tax-exempt status is conferred for purposes of exemption from tax.

Federal tax law provides tax benefits to nonprofit organizations recognized as exempt from federal income tax and those organizations are required to comply with federal tax law to maintain tax-exempt status and avoid penalties.

There are 28 different paragraphs under IRC section 501(c) under which an organization can qualify for federal tax-exempt status. The more commonly known tax-exempt organizations are those recognized by the Internal Revenue Service (IRS) under IRC section 501(c)(3).

*IRC Section 501(c)(3) – Charitable Organizations*

Tax-exempt organizations recognized under this IRC section include public charities (e.g., United Way, Salvation Army, churches, hospitals, schools, colleges) and private foundations (e.g., Bill and Melinda Gates Foundation, Ford Foundation, The California Endowment, Rockefeller Foundation).

*IRC Section 501(c)(19) – Veterans’ Organizations*

Tax-exempt organizations recognized under this IRC section are, in general, organizations that benefit veterans of the United States Armed Forces. The IRC<sup>1</sup> defines “Armed Forces of the United States” to include all regular and reserve components of the uniformed services which are subject to the jurisdiction of the Secretary of Defense, the Secretary of the Army, the Secretary of the Navy, or the Secretary of the Air Force, and also includes the Coast Guard.

IRC section 501(c)(19) provides for the exemption from federal income tax of a post or organization of past or present members of the United States Armed Forces if :

- a) It is organized in the United States (U.S.) or any of its possessions;
- b) At least 75 percent of its members are past or present members of the U.S. Armed Forces;
- c) Substantially all of its other members are individuals who are cadets or are spouses, widows, widowers, ancestors or lineal descendants of past or present members of the U.S. Armed Forces or of cadets; and
- d) No part of the net earnings of which inures to the benefit of any private shareholder or individual.

Although not all tax-exempt organizations are required to submit a tax-exempt application with the IRS to be tax-exempt, they may wish to apply to receive a determination letter of IRS recognition of their IRC section 501(c) status in order to obtain certain incidental benefits such as:

- Public recognition of tax-exempt status
- Exemption from certain state taxes
- Advance assurance to donors of deductibility of contributions (in certain cases)
- Nonprofit mailing privileges, etc.

**STATE LAW**

Obtaining state tax exemption is a separate process from obtaining federal exemption.

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<sup>1</sup> IRC section 7701(a)(15).

Currently, in order to obtain state exemption from tax under Revenue and Taxation Code (R&TC) section 23701w,<sup>2</sup> 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 the FTB indicating the organization is exempt from tax. The exemption application is required to include the organization's Articles of Incorporation, bylaws, and financial statements showing assets, liabilities, receipts, and disbursements.

To be exempt from state tax, an organization must be organized and operated for one or more exempt purposes listed in California's Corporation Tax Law.

Beginning in 2008, organizations that received a federal determination of tax-exempt status under IRC section 501(c)(3) could obtain state tax-exempt status using a streamlined process by submitting only a copy of the federal determination to the FTB.<sup>3</sup> Beginning in 2013, the streamlined application process was extended to include organizations that received a federal determination of tax-exempt status under IRC sections 501(c)(4), 501(c)(5), 501(c)(6), or 501(c)(7).

Under the streamlined process, the FTB is allowed to revoke tax-exempt status if the organization fails to meet certain California provisions governing exempt organizations.

Also, an organization must inform the FTB of the suspension or revocation of the federal tax-exempt status and, upon receipt of the IRS notice of suspension or revocation, the FTB is allowed to suspend or revoke the organization's state tax-exempt status.

Current law prohibits an organization formed as a California corporation or qualified to do business in California that is listed by the Secretary of State (SOS) or the FTB as "suspended" or "forfeited" from establishing its exemption from state income taxes and provides that the organization will not receive an acknowledgement from the FTB of the organization's exemption until that corporation is listed by the SOS and the FTB as an "active" corporation.

## **THIS BILL**

This bill would allow an organization that is federally tax-exempt under IRC section 501(c)(19) to submit a copy of its IRS tax-exempt determination letter to the FTB to establish its state tax-exempt status. As a result, these organizations would no longer be required to file an exemption application with the FTB or submit a \$25 filing fee. Instead, they would receive their state tax exemption automatically by informing the FTB of the IRS tax exemption and submitting a copy of their IRS determination letter.

These organizations would continue to receive an acknowledgement letter issued by the FTB verifying their exemption from state tax. Any organizations that are not issued a federal determination letter could still file an application to obtain California tax-exempt status.

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<sup>2</sup> R&TC section 23701w allows a veterans' organization to receive tax-exempt status for state purposes.

<sup>3</sup> R&TC section 23701d(c)(1).

This bill specifies that veterans' organizations would be subject to the same provisions that apply to the streamlined process under current state law.

### **IMPLEMENTATION CONSIDERATIONS**

Implementing this provision would require some changes to existing tax forms and instructions, and information systems, which could be accomplished during the normal annual update.

### **TECHNICAL CONSIDERATIONS**

A reference to R&TC section 23701w should be added to the listing in subdivision (d) of section 23701 (page 2, line 18) for consistency and accuracy.

### **LEGISLATIVE HISTORY**

AB 1173 (Bocanegra, Chapter 536, Statutes of 2013) allows an organization that has obtained a ruling or determination from the IRS that it is exempt from federal income taxes as an organization described in Section 501(c)(3), (c)(4), (c)(5), (c)(6), or (c)(7) of the IRC to use the streamlined method of applying for tax-exemption for state purposes.

AB 831 (Silva, 2011/2012) would have exempted a single-member limited liability company from the annual tax and annual fee. Also this bill would have prohibited an organization that is listed by the SOS or the FTB as "suspended" or "forfeited" from establishing its California tax-exempt status and would have provided that the organization would not receive an acknowledgement from the FTB of the organization's exemption until that corporation is listed by the SOS and the FTB as an "active" corporation. AB 831 failed to pass out of the Assembly Revenue and Taxation Committee.

AB 404 (Eng, Chapter 504, Statutes of 2009) eliminated the requirements for certain tax-exempt entities that are granted a federal group exemption to apply separately for state tax exemption, and allowed the FTB to permit inspection of certain exemption documents.

AB 897 (Houston, Chapter 238, Statutes of 2007) eliminated the requirement for filing a separate application for state tax-exempt status for certain organizations that receive federal tax-exempt recognition. The organization seeking state tax-exempt status must, however, submit to the FTB its IRS tax-exempt 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. A review of the laws of these states found that all six states require exempt organizations to apply for tax-exempt status.

### **FISCAL IMPACT**

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

**ECONOMIC IMPACT**

This bill would result in the following revenue loss:

Estimated Revenue Impact of AB 94 As Introduced on January 10, 2017 Assumed Enactment After June 30, 2017		
2017-18	2018-19	2019-20
\a	\a	\a
\a revenue loss less than \$5,000		

This analysis does not account for changes in employment, personal income, or gross state product that could result from this bill.

**Revenue Discussion**

The FTB data indicates that there were 650 exempt organizations filing as veterans' organizations in 2016. It is estimated that the FTB would receive 50 applications from veterans' organizations each year. It is assumed that 70 percent of these new organizations would apply with the IRS and receive the federal exemption. It is further assumed that of those organizations with a federal exemption, 75 percent would file for an exemption with California using the streamlined process (filing FTB Form 3500A that has no filing fee rather than the FTB Form 3500 and the \$25 filing fee). The result of 26 organizations was multiplied by the \$25 filing fee that would have been collected with FTB Form 3500 and would not be collected when the FTB Form 3500A is used. This results in an estimated revenue loss of less than \$5,000 annually.

The tax year estimates are converted to fiscal year estimates and then rounded as reflected in the above table.

**SUPPORT/OPPOSITION**

Support: None provided.

Opposition: None provided.

**ARGUMENTS**

Proponents: Supporters may argue that this provision would allow veterans' organizations applying for tax-exempt status in California to eliminate the duplicative application process saving the organizations money and time.

Opponents: Some may argue that the FTB should continue the application process to better control the organizations that are recognized as tax-exempt for California.

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