

The IRS' temporary pause in accepting group exemption applications offers exempt organizations a chance to reevaluate the merits of the group exemption regime



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On Sunday, August 16, 2020, the Internal Revenue Service (IRS) concluded its public comment period on proposed changes to the group exemption letter program. In [Notice 2020-36](#) published earlier this spring, the IRS released a proposed revenue procedure, setting forth an updated process for obtaining and maintaining group exemption letters. From June 17, 2020, until the proposed guidance on the group exemption process is finalized, the IRS will not accept any requests for group exemption letters.

What is a group exemption letter?

A group exemption letter is a ruling or determination that the IRS issues to a qualified central or parent exempt entity (typically, a statewide, regional or national organization) which allows one or more subordinate organizations (often, local units, chapters or associations) to obtain exempt status without separately applying.

In most cases, the primary benefit of a group exemption letter is that the subordinates are not required to provide the IRS with individualized documentation to support their exemption applications and pay separate fees. Additionally, in certain cases, subordinates can be included on group Form 990 information returns filed by the parent, avoiding the need for separate annual information returns for each subordinate. Group exemption letters can save substantial amounts of organizational time and cost when compared with individual IRS determination letters. It is always valuable for potential parent organizations to consider the viable alternatives to group exemption letter applications for groups of affiliated exempt entities. In some cases, these alternatives offer nonprofit governance benefits that a group exemption letter would not provide. Benefits can range from more control over subordinates, reduced administrative and governance complexity, effectively a faster path to exempt status approval, streamlined fundraising, and reduced potential liability for acts of subordinates.

Direct activity by central or parent organizations

A parent or central organization that would otherwise seek a group exemption letter could instead engage in regional, state or local activity directly without forming separate subordinate organizations. Regional, state or local activity could be conducted directly through:

- Branches or divisions, inseparable from the parent for legal purposes (although they could potentially have separate doing business as names at the state or local level)
- Semi-autonomous committees of the parent (nominally having some degree of independent governance through the members appointed to operate the committee, but ultimately being subject to the complete control of the parent organization's board of directors)

The information contained herein is based on a summary of legal principles. It is not to be construed as legal advice and does not create an attorney-client relationship. Individuals should consult with legal counsel before taking any action based on these principles to ensure their applicability in a given situation.

As compared with a group exemption letter covering separately organized corporate subsidiaries, the principle benefits of this type of direct action are organizational simplicity and centralized control. It is not necessary to form separate organizations in each state/locality with their own articles of incorporation/organization and bylaws and the branches, divisions or committees of the parent are subject to the complete control and domination of the parent organization.

Additionally, it would not be necessary to apply to the IRS for approval of this structure like a group exemption application, wait six months to a year for review and keep up with annual compliance requirements for a separate organization during the interim period. Avoiding the need to wait for approval could improve the ability of subordinates to fundraise from donors that may be concerned to make grants to entities with pending exempt status, given that donors may be giving directly to a parent or central organization that holds a determination letter.

The principal downside of direct activity is that a parent organization would be liable for all of the acts of its regional, state or local affiliates because they would all be part of the same legal entity as the parent organization. A potential solution to this downside would be to organize each local affiliate as a single member limited liability company (SMLLC) wholly owned by the parent. For federal income tax purposes, each such SMLLC would be considered a part of the parent organization, benefiting from its tax-exempt status, but for state law purposes the existence of the SMLLC would generally shield the parent from liability for the acts of the local affiliate (assuming proper formalities and other steps were taken such that the existence of the SMLLC was respected). SMLLCs could also be created with separate boards of directors or officers to allow for some degree of local governance and independent decision-making, while ultimately being subject to the control of the parent organization.

Fiscal sponsorship by central or parent organizations

Instead of applying for a group exemption letter, a parent organization could instead pursue a form of fiscal sponsorship, such as the pre-approved grant relationship model (Gregory L. Colvin, author of the principal treatise on fiscal sponsorship, calls this Model C). Under this model, an individual or organization without exempt status (a “project”) applies to a parent organization (a “fiscal sponsor”) asking the fiscal sponsor to support a project consistent with fiscal sponsor’s tax-exempt purposes.

After approval of the application and entrance into a fiscal sponsorship agreement requiring periodic review and reporting by the project to the fiscal sponsor, a project could engage in regional, state or local activity, financially supported by the fiscal sponsor. When properly executed by a Section 501(c)(3) public charity as fiscal sponsor, this fiscal sponsorship format facilitates fundraising. The format allows eligible donors to obtain a charitable deduction immediately without the risks of donating to organizations with pending exempt status. As compared with seeking a group exemption letter for a parent or central organization that covers subordinates, the primary benefit of this type of fiscal sponsorship is that an application to the IRS is not required and a project may not have to file their own Form 990 information returns, depending on their structure. Therefore, there is not a six month or longer waiting period while the application is reviewed and the various annual reporting and other compliance requirements applicable to group exemption letter holders and subordinates do not apply. Additionally, potential donors who are only willing to make grants to a public charity with a determination letter in place (such as certain donor advised funds or private foundations) would be able to make grants immediately and not six to twelve months later when the group exemption letter is approved. Nevertheless, certain donors that are less familiar with the fiscal sponsorship process may require some explanation before they make grants.

Formation of low-cost, small affiliates

As an alternative to seeking a group exemption letter, each potential subordinate under a group exemption letter could apply for its own separate tax-exempt status on Form 1023-EZ Streamlined Application for Recognition of Exemption Under Section 501(c)(3). This streamlined application is generally available to entities seeking exempt status under Section 501(c)(3) that expect under \$50,000 in annual gross receipts, have under \$250,000 in assets and meet certain other technical requirements.

For many years, it was intimidating, labor intensive and slow for a new exempt organization to apply for tax-exempt status. The current fee for filing the full Form 1023 Application for Recognition of Exemption Under Section 501(c)

(3) is \$600 (it was \$850 prior to July 1, 2016) and the document is approximately 17 pages long (with 23 pages of supplemental schedules applicable to certain applicants). Typically, Form 1023 applications take approximately six months to review, but backlogs in the past caused review time to exceed nine months on average. In contrast, Form 1023-EZ applications cost only \$275 and typically take fewer than 90 days for the IRS to review. Additionally, a Form 1023-EZ is only two pages long plus a signature page and is typically perceived as simple enough to be filled out by a non-tax professional, potentially reducing preparation costs. A potential alternative to seeking a group exemption application would be for a parent organization to ask all potential subordinates/affiliates to separately apply for tax-exempt status on Form 1023-EZ. If all of the subordinates had substantially similar purposes and formation documents, the applications could be nearly identical but for the names, addresses, and names of officers and directors.

One of the primary benefits of an approach using separate Form 1023-EZ applications for each subordinate would be that the IRS review process would typically be under three months as opposed to six to 12 months for a group exemption letter. Additionally, each subordinate would have its own separate IRS determination letter. Thus, a subordinate's activities would not necessarily be directly or indirectly attributed to the parent (potentially endangering the parent's exempt status, if a subordinate were to engage in inappropriate activities). The benefits of this approach would potentially outweigh the costs if the number of potential subordinates in a group were up to a few dozen. In cases where scores or hundreds of affiliates were anticipated, the group exemption letter application process might still save significant time and overall preparation fees (when it reopens with final guidance).

Exempt organizations should take advantage of this time period while the IRS finalizes guidance to review whether the group exemption program is right for them. Contact a member of Godfrey & Kahn's Taxation practice group to discuss.