D. STATUTE OF LIMITATIONS FOR EXEMPT ORGANIZATION RETURNS

1. Introduction

The article in the 1981 CPE textbook regarding the statute of limitations for exempt organization cases has generated several questions over the past year. In order to best illustrate the application of the statute of limitations under various circumstances, we will discuss several hypothetical situations and answer several questions.

2. IRC 4941 and 4942: Form 990-PF and Form 4720

All private foundations are required to file an annual return on Form 990-PF no later than the 15th day of the 5th month following the close of the organization's accounting period. Part V of Form requests information regarding any acts that might result in a tax under Chapter 42 of the Code. In the event that any liability is indicated, the person liable (i.e., the foundation, the foundation manager, or self-dealer) is directed to file Form 4720. The due date for filing Form 4720 for persons having the same tax year as the foundation is on or before the due date for the filing of Form 990-PF. For persons whose tax year ends on a different date, Form 4720 must be filed on or before the 15th day of the fifth month following the close of that person's tax year.

Situation 1: X is a private foundation with a tax year ending November 30. Y is a disqualified person and a calendar year taxpayer. For the fiscal years ending in 1976 and 1977, X filed Form 990-PF on the due date and in good faith answered all the questions regarding liability for IRC 4941 tax negatively. There was no indication on either return that any self-dealing act had occurred. During an examination in 1981, it was discovered that on December 3, 1976, X purchased a building from Y resulting in an act of self-dealing under IRC 4941. No Form 4720 had been filed with respect to this transaction.

Questions:

1. Which Form 990-PF, November 1976, or November 1977, begins the statute of limitations on the act of self-dealing?

2. If Y, the self-dealer, files a Form 4720 on May 15, 1977, does the statute begin to run from that date for him?

3. Does a three or six year statutory period of limitations apply?

4. If a consent to extend the statute is needed, should one be secured on the Form 990-PF or is a consent from the self-dealer needed?

1. IRC 6501(n)(1) provides that for purposes of any tax imposed by Chapter 42, the return referred to is the return filed by the private foundation for the year in which the act giving rise to liability for such tax occurred. Proposed Reg. 301.6501(n)-1(a)(1) explicitly provides that for purposes of determining the period of limitations under IRC 6501 the return of the private foundation is considered the return of all persons required to file a return with respect to any Chapter 42 tax, even if all those persons did not sign the return, and even if the foundation (in good faith) incorrectly answers the questions pertaining to liability under Chapter 42.

The act of self-dealing referred to in the example occurred during X's fiscal year ending November 30, 1977, and should have been reported on the Form 990-PF for that year. Thus, the filing of the 1977 Form 990-PF on April 15, 1978, would start the running of the statute of limitations on the act of self-dealing, even though that return gave no indication of the self-dealing act.

2. Referring to proposed Reg. 301.6501(n)-1(a)(1), it is clear that Y's filing of Form 4720 would have no effect on the period of limitations imposed by IRC 6501. Thus, the statute of limitations as to Y starts on April 15, 1978, the date X filed its Form 990-PF, even though X incorrectly answered the questions pertaining to IRC 4941. However, see answer to question three for the length of the statutory period.

3. IRC 6501(e)(3) provides that if a return omits an amount of Chapter 42 tax exceeding 25% of the amount of such tax reported, the tax may be assessed within six years after the return was filed unless the transaction giving rise to the tax is disclosed on the return, or in a statement attached to the return, in a manner sufficient to apprise the Service of the existence and nature of the item. Proposed Reg. 301.6501(e)-1(c)(3)(ii) provides that with respect to any Chapter 42 tax, other than that imposed by IRC 4940, if a private foundation discloses an item in its return or in an attached schedule or statement in a manner sufficient to apprise the Service of the existence and nature of the item the three year limitation on

assessment and collection will apply to any tax arising from the disclosed transaction. If an item is not so disclosed in the foundation's return or attached schedule, the tax may be assessed any time within six years. What constitutes sufficient disclosure is, of course, a factual determination. (See 1981 CPE Text p. 233.)

It is noted that the proposed regulation is silent on the statutory 25% omission test with regard to Chapter 42 tax. The implication of the proposed regulations is that each Chapter 42 violation is treated separately when applying the 25% test. Thus, any single act resulting in a Chapter 42 violation that is not properly disclosed is automatically a 100% omission and is sufficient to activate the six year statutory period on that act. This should be clarified in the final regulations.

Thus, in the hypothetical example, the six year statutory period of limitations would apply because X did not disclose sufficient information for the Service to ascertain that the act of self-dealing had occurred.

4. IRC 4941 imposes a tax upon the disqualified person rather than the private foundation. Reg. 301.6501(c)-1(d) provides that the statute of limitations may be extended at any time prior to its expiration for any period of time agreed upon in writing by the taxpayer and the district director or assistant regional commissioner. An extension of the statute on Form 990-PF by X will not protect the statute against the self-dealer. Y is the taxpayer and, thus, any extension must be obtained directly from Y.

Situation 2: X, a private foundation, with the calendar year as its tax year, filed its 1977 Form 990-PF timely on May 15, 1978 and in good faith answered negatively all the questions concerning Chapter 42 liability. An examination was initiated on the 1977 Form 990-PF on June 1, 1981, during which it was noted that a disqualified party sold real estate in 1977 to the foundation for $ 100,000, its fair market value. No Form 4720 was filed and no correction of the self-dealing act has ever been made. There was sufficient information on the 1977 Form 990-PF to indicate the act of self-dealing.

Questions:

1. May the first level tax under IRC 4941(a) be assessed for any period?

2. May the second level tax under IRC 4941(b) be assessed for any period?

1. Reg. 53.4941(e)-1(e)(i) provides that a transaction between a private foundation and a disqualified person, other than the leasing of property, the lending of money or property or the payment of compensation, is one act of self-dealing. The act of self-dealing is treated as occurring on the date the terms and conditions of the transaction and the liabilities of the parties are fixed. Thus, in the example given, the sale of the property to the foundation is not a continuing transaction, but is considered one act of self-dealing occurring in 1977.

The statute of limitations on this act of self-dealing is governed by the filing of the foundation's Form 990-PF. This was filed timely on May 15, 1978. Pursuant to IRC 6501(a) any amount of tax imposed on this transaction must be assessed within three years after the return was deemed filed. The six year statute under IRC 6501(e)(3) would not be applicable since the act was disclosed on the 1977 Form 990-PF. Thus, the statute of limitation for the assessment of the first level tax expired on May 15, 1981, and no amount may be assessed thereafter.

2. IRC 4941(b) imposes additional taxes on self-dealers where the initial tax is imposed by IRC 4941(a) and the act of self-dealing is not corrected within the taxable period. It has been argued, notwithstanding the IRC 6501 bar to assessment on the first level taxes, that the second level taxes can and should be imposed and assessed where the self-dealing act has not been corrected. This is because the tax under IRC 4941(b) depends only on the imposition of the first level tax and not its assessment and IRC 6501 bars the assessment of the first level tax and not the imposition. It is further argued that IRC 4941(b) imposes tax on the failure to correct the act of self-dealing rather than on the act itself. Under this theory, in situations such as the example, there would be no limitation on the assessment of the second-level tax. Thus, if in the example the audit was conducted in the year 2021, the second-level tax would be assessable.

Although this argument has some appeal and it appears to further the purposes of Chapter 42 insofar as forcing corrections of violations, it is our opinion that it is incorrect. The better analysis is one that would give effect to the Congressional intent underlying the statute of limitations and favoring a definite limitation of liability.

Under IRC 4941(e)(1), as amended by P.L. 96-596, (December 24, 1980), the term "taxable period" means the period beginning with the date on which the act of self-dealing occurs and ending on the earliest of: (1) the date of mailing a notice of deficiency with respect to tax imposed by IRC 4941(a)(1); (2) the date on which the tax imposed by IRC 4941(a)(1) is assessed; or (3) the date on which correction of the act of self-dealing is completed. In the hypothetical example none of these three events has occurred and thus, the taxable period has not ended. The second level tax cannot be imposed until the end of the taxable period. In the example, the taxable period can end only when correction takes place since the Service is foreclosed by the statute of limitations with respect to assessing the first level tax. Of course, in the event correction does take place, there would be no liability for the second level tax. Thus, we believe that the second level tax under IRC 4941(b) may not be assessed after the expiration of the statute of limitations for assessment of the first level tax under IRC 4941(a).

The foregoing analysis with respect to the second level tax is applicable to assessments after December 24, 1980, the effective date of P.L. 96-596. P.L. 96-596, among other things, changed the operative period in IRC 4941(b) from the "correction period" to the "taxable period." However, we believe the result would be the same for the prior years because of the Congressional intent underlying the statute of limitations, i.e., foreclosing any assessment of tax at a definite point in time. In addition, under Adams v. Commissioner, 72. T.C. 81 (1979), the second level tax is probably unenforceable under prior law. (Both parties have appealed to the 2nd Cir.)

Because there are no regulations under IRC 6501(n) offering guidance in this area, we suggest that cases involving this issue be referred to the National Office for technical advice.

Situation 3: X, a private foundation using the calendar year as its tax year, filed its 1977 Form 990-PF on May 15, 1978. All subsequent annual returns were also filed timely. An examination initiated on January 1, 1981, revealed that on July 30, 1977, X entered into a five year lease for an office building owned by Y, a disqualified person. This transaction was revealed on the 1977 return and referred to in subsequent returns, resulting in the three year statute of limitations. No Form 4720 was filed, however, and no tax was paid. The case is unagreed.

Questions:

1. For which years may the first level taxes under IRC 4941(a) be assessed?

2. For which years must the statute of limitations be protected?

1. If a transaction between a private foundation and disqualified person is determined to be self-dealing, there is generally one act of self-dealing occurring on the date the terms and conditions of the transaction and the liabilities of the parties are fixed. However, if the transaction relates to the leasing of property, the lending of money or other extension of credit, other use of money or property or payment of compensation, the transaction will be treated for purposes of IRC 4941 as giving rise to an act of self-dealing on the day the transaction occurs plus an additional act of self-dealing on the first day of each succeeding taxable year or portion of a taxable year within the taxable period. Reg. 53.4941(e)-1(e).

Thus, in the example, the leasing of the building from Y results in an act of self-dealing occurring on July 30, 1977, plus an additional act of self dealing occurring on January 1, 1978, January 1, 1979, January 1, 1980, and January 1, 1981.

Pursuant to IRC 6501(n) the statute of limitations starts for an act of self-dealing when the foundation's return for the year in which the act occurred is filed. Thus the statute of limitations for the initial act of self-dealing starts on May 15, 1978, the date on which the 1977 Form 990-PF was filed and, since the three year statute applies, will expire on May 15, 1981. The statute of limitations for the act of self-dealing deemed to have occurred on January 1, 1978, starts on May 15, 1979, and expires May 15, 1982, and so on for the subsequent years.

Since the statute of limitations has not expired on any year, first level taxes may be assessed for all years in the taxable period for each separate act of self dealing, i.e., the one occurring on July 30, 1977, and the subsequent acts occurring on January 1, 1978, 1979, 1980 and 1981.

2. Since the three year statute of limitations applies, the period for assessment of the first level taxes on the 1977 tax year will expire on May 15, 1981. Since the case is unagreed and will be forwarded for higher review the examiner working the case should get a consent to extend the statute of limitations for the year 1977. The statute need only be extended for the 1977 year rather than for each year in the taxable period since the tax is deemed imposed in that year even though the amount of tax to be imposed is computed with reference to each year in the taxable period.

The statute, with respect to the subsequent acts deemed to have occurred on January 1, 1978, January 1, 1979 etc., must be protected separately. Thus, for example, the statute with respect to the act occurring on January 1, 1978 (and expiring on May 15, 1982) is protected by securing a consent for the year 1978.

[The above answer provides that the statute need only be extended for the year in which the self-dealing act occurs because the tax is imposed in that year and the amount is computed with reference to each year in the taxable period. While we are almost sure that this answer is correct, as of this writing it is not confirmed by a written legal opinion of the Chief Counsel's Office. However, by the time this topic is presented we expect to have a written legal opinion and your instructor will provide the correct answer. In addition, as soon as we have a legal opinion we will incorporate that answer in the IRM.]

Situation 4: X, a private foundation using the calendar year as its tax year, filed its 1975 Form 990-PF timely on May 15, 1976. All subsequent annual returns were also filed timely with sufficient information to indicate that the foundation had undistributed income in 1975 and 1976. An examination was initiated on the 1978 Form 990-PF on January 1, 1981, which disclosed the following:

	1975	1976	1977	1978
Distributable Amounts	300	400	350	400
Qualifying Distributions	-0-	100	100	800

Questions:

1. May the first level tax be assessed for the undistributed income of 1975 or 1976?

2. May the second level tax be assessed for the undistributed income of 1975?

1. IRC 4942(a) imposes an initial excise tax on the undistributed income of a private foundation for any taxable year, which has not been distributed before the first day of the second taxable year following such taxable year. The initial excise tax is 15% of the amount of undistributed income remaining undistributed on that first day. The initial excise tax is also imposed on any undistributed income of the taxable year remaining undistributed on the first day of succeeding taxable years within the taxable period. The taxable period with respect to the undistributed income of a taxable year begins with the first day of the taxable year and ends on the earlier of: (1) the date of mailing of a notice of deficiency with respect to the tax imposed by IRC 4942(a); or (2) the date on which the tax

imposed by that section is assessed. Thus, failure to distribute income of a particular taxable year may result in an initial excise tax based on the amount of undistributed income remaining with respect to that taxable year on the first day of succeeding taxable years.

In general, qualifying distributions made during a taxable year are treated as made first out of the undistributed income of the preceding year, second out of the undistributed income for the taxable year, and then out of corpus. Reg. 53.4942(a)-3(d).

In our example, in 1976 the qualifying distribution of $ 100 is treated as made out of the undistributed income of $ 300 for 1975. This results in undistributed income for 1975 of $ 200. This amount remains undistributed in 1976, 1977, 1978, etc. In 1977, the qualifying distribution of $ 100 is treated as made out of the undistributed income of $ 400 for 1976. This results in undistributed income of $ 300 for 1976. This amount remains undistributed in 1977, 1978, 1979, etc.

Under IRC 4942(a) the foundation had until the end of 1976 to distribute the 1975 income without incurring an initial tax. The failure to distribute was reported on the 1976 Form 990-PF. The due date for the 1976 return was May 15, 1977. Pursuant to IRC 6501(n), the statute of limitations starts with the filing of the return for the year in which the act (or failure to act) giving rise to such liability occurs. Since the three year statute applies, the period for assessment of the initial tax on the undistributed income for 1975 expired on May 15, 1980. Thus, the first level tax on the 1975 undistributed income cannot be assessed for any year.

The undistributed amount for 1976, calculated at the end of 1977, is $ 300. The failure to distribute this amount was reported on the Form 990-PF filed on May 15, 1978. The statute of limitations on the assessment of first level tax on the 1976 failure to distribute income does not expire until May 15, 1981. The initial 15% excise tax could therefore be assessed on the amount remaining undistributed in each year in the taxable period.

2. IRC 4942(b) imposes a second level tax in any case in which an initial tax is imposed on the undistributed income of a private foundation for any taxable year, if any portion of that income remains undistributed at the close of the taxable period.

Arguments similar to those supporting the imposition of the second level tax under IRC 4941(b), after the expiration of the statute of limitations on the assessment of the first level tax, may be made to support such a result under IRC 4942(b). See discussion under Situation 2.

It is our opinion, however, as in our analysis under IRC 4941, that no second level tax may be imposed until the expiration of the taxable period. Since none of the events marking the end of the taxable period has occurred, the taxable period has not ended. Thus, no second level tax may be assessed after the expiration of the statute of limitations for assessment of the first level tax under IRC 4942(a).

3. Nonexempt Charitable Trusts (NECT) Under IRC 4947(a)(1): Form 5227

Every trust described in IRC 4947(a)(1) that is a private foundation under IRC 509(a) is required to file an annual return on Form 5227 (Form 990PF starting with the year 1981). See Reg. 301.6011-1(d). IRC 6012 also requires fiduciaries of such trusts to report any taxable income of the trust on Form 1041. Reg. 301.6012-3(a)(7) indicates, however, that in the event the trust has no taxable income, the filing of Form 5227 will satisfy this requirement.

Situation 1: X is described in IRC 4947(a)(1) and is a private foundation. The trustee filed Form 1041 for the 1978 tax year in a timely manner. No indication was made on Form 1041 to indicate that the trust was an NECT and no Form 5227 was filed.

Question: Does the filing of Form 1041 start the statute of limitations for assessing Chapter 42 taxes?

Proposed Reg. 301.6501(n)-1 provides special rules for Chapter 42 taxes. It states that the return filed by the private foundation shall be considered for purposes of IRC 6501 to be the return of all persons required to file a return with respect to such taxes. The return specifically referred to in the case of an NECT is Form 5227. Thus, the filing of Form 1041, whether or not information was provided in that return regarding liability for any tax under Chapter 42, will not of itself commence the running of the statute of limitations.

Situation 2: X is an NECT. X never applied for a determination of its foundation status but filed form 1041 for the year 1979 in the belief that it qualified as a public charity. An examination later resulted in the determination that X was a private foundation.

Question: Does the filing of Form 1041 in this situation start the statute of limitations with respect to Form 5227?

In this case X cannot rely on its mistaken determination that it qualified as a public charity since it failed to request a ruling from the Service. As indicated above, IRC 6501(n) requires Form 5227 to be filed by an NECT that is a private foundation in order to commence the running of the statute of limitations. The filing of Form 1041 will not start the statute of limitations with respect to any liability under Chapter 42 and since no return has been filed, the tax may be assessed or a proceeding in court for the collection of the tax may be begun without assessment at any time.

4. IRC 511 Tax: Form 990-T

Each tax exempt organization, with certain very limited exceptions, having gross income of $1000 or more for the taxable year from an unrelated trade or business, must file a tax return on Form 990-T, Exempt Organization Business Income Tax Return, and pay any tax due. The obligation to file Form 990-T is in addition to the obligation to file any other required returns. Reg. 301.6012-2(e).

If a return is not filed, IRC 6501(c)(3) provides an exception to the general rule that assessment of tax must be made within three years. In such case assessment may be made at any time. Since the publication of Rev. Rul. 69-247, 1969-1 C.B. 303, the Service position has been that the "failure to file" exception of IRC 6501(c)(3) does not apply to Form 990-T if the organization files in good faith an information return that discloses sufficient information to apprise the Service of the nature and extent of the unrelated business that should have been reported on Form 990-T. Thus, the "good faith" filing of Form 990, Form 990-PF, or Form 5227 containing sufficient information for the Service to ascertain that the organization had unrelated business income would start the statute of limitations for purposes of assessing the unrelated business income tax. (See discussion in 1981 CPE Text.) In this case, "good faith" means that the organization did not know that some of its income was taxable as unrelated business income.

What constitutes sufficient disclosure is, of course, a question of fact. Because we have been asked, we are providing some hypothetical factual situations and indicating whether we believe sufficient disclosure would result. These hypotheticals should not be relied on nor applied to real cases. In actual cases <u>all</u> the facts and circumstances must be considered and these hypotheticals contain a limited number of facts. They are discussed for general guidance only.

Situation 1: A golf club exempt under IRC 501(c)(7) operates a golf course and restaurant for members. The club filed Form 990 for 1977, but did not file Form 990-T. In addition, the club answered "no" to the question on Form 990 relating to the use of facilities by non-members. The Form 990 reflected the following:

Dues	$ 10,000
Restaurant Sales	$ 90,000
Golf Course expense	$ 40,000
Restaurant expenses	$ 45,000

An examination revealed that the club allowed the use of its facilities by the general public which generated unrelated business income of $20,000.

Questions:

1. Is the information reflected on Form 990 sufficient to begin the statute of limitations on the assessment of the unrelated business income tax? If not, when does the period of limitations for assessment start?

2. If Form 990 included an entry of $ 10,000 for interest income would that have been sufficient to apprise the Service of the existence of unrelated business income for the purpose of starting the statute of limitations?

3. If the organization filed Form 990-T on its due date indicating gross income of $ 10,000 from unrelated trade or business (one-half of the amount that should have been reported), when would the statute of limitations start and for what period of time would it run?

1. IRC 501(c)(7) exempts from Federal income tax, clubs organized for pleasure, recreation and other non-profitable purposes, substantially all of the activities of which are for such purposes and no part of the net earnings of which inures to the benefit of any private shareholder. The items reflected on Form 990 represent typical income and expenses of a recreational club and in no way apprise the Service of the nature and amount of any unrelated business income. There is no clue as to the existence of unrelated business income. Since the Service is not required to play Sherlock Holmes in disclosure matters, we conclude that under

these circumstances the filing of Form 990 is not sufficient to start the statute of limitations on the assessment of unrelated business income tax. IRC 6501(c)(3) provides that when there is a failure to file a return, the tax may be assessed at any time. Thus, the period of limitations for assessment of the tax on unrelated business income tax has not started.

2. Under IRC 512(a)(3)(B) interest income of IRC 501(c)(7) clubs is includible in the calculation of unrelated business income. Thus, an item reflecting interest income would probably be sufficient to give notice to the Service of the existence of such income. Therefore, the filing of Form 990 revealing this information would probably be sufficient to start the running of the statute of limitations for the assessment of IRC 511 tax.

3. IRC 6501(e) provides an exception to the three year period of limitations for substantial omissions. If the taxpayer omits from gross income an amount properly includible in excess of 25% of the gross income stated in the return, the tax may be assessed any time within six years after the return was filed. Therefore, since the organization filed a Form 990-T but omitted 50% of the gross income includible, the six year statute would apply and the period would commence when Form 990-T was filed.

Situation 2: A college filed Form 990 for 1977 reflecting Gross Rents from Dormitory Rental of $ 250,000. Its balance sheet shows Mortgage Payable of $ 2,000,000. An attached property schedule identifies 10 buildings as security for the mortgage, 5 of which are dormitories. The block indicating no liability to file Form 990-T was checked. An examination revealed that the Gross Dormitory Rental income included summer rental of dormitories for outside conferences which was subject to tax under IRC 511 and 514.

Questions:

1. Was sufficient information revealed on the return to start the period of limitations on the assessment of the unrelated business income tax?

2. If the rents were identified only as Gross Rents and the property schedule included a hockey rink, an auditorium, a sports complex and an administrative building, would sufficient information have been supplied to start the running of the statute of limitations?

1. The information reflected on Form 990 represents normal items for a college. As such, they give no clue to the existence of unrelated business income. Therefore, IRC 6501(c)(3) applies and the tax may be assessed at any time.

2. A hockey rink, an auditorium, and a sports complex are normal buildings in which to conduct a university's exempt activities and their listing accompanied by "Gross Rents" does not give an adequate clue as to the existence of unrelated income. The IRC 511 tax could, therefore, be assessed at any time.

<u>Situation 3</u>: A private foundation filed Form 990-PF providing the following information:

Interest and Dividends	$ 50,000
Rents	$ 20,000
Mortgage Interest Expense	$ 10,000
Depreciation	$ 3,000

All questions on Form 990-PF pertaining to IRC 511 tax were answered "no" or "not applicable." An examination revealed that the rental property was debt financed.

<u>Question</u>: Was sufficient information provided on Form 990-PF to start the period of limitations for the assessment of the tax on unrelated business income?

Under these circumstances the presence of entries for rents and for mortgage interest expenses would probably give the Service a sufficient clue to the existence of liability for tax as a result of income from debt financed property. The main difference between this situation and the IRC 501(c)(7) examples is that it is not normal for a private foundation to have rental income. However, an analysis of all the information would have to precede any decision on such a close case.

<u>Situation 4</u>: X is a public charity using the calendar year as its taxable year. Its receipts are normally less than $ 10,000 and no Form 990 or 990-T has ever been filed. An examination was initiated for the 1978 tax year on June 1, 1980, and it was noted then that the organization received $ 5,000 from unrelated trade or business in the 1978 tax year. Further information revealed that the unrelated activity with similar income commenced in 1975.

<u>Question</u>: For what periods may the tax under IRC 511 be assessed?

X is not required to file Form 990 under IRC 6033. The fact that it is relieved from filing information returns, however, does not relieve it from the requirement of reporting unrelated business income on Form 990-T under Reg. 301.6012-2(e). Since no return has ever been filed by X the statute of limitations on the assessment of IRC 511 tax has never started to run. Therefore, pursuant to IRC 6501(c) the IRC 511 tax be be assessed for all years from 1975 to the present.