

FEDERAL TAXATION

Prohibited Transactions—§ 7972

§ 7968. Renewed exemption applications. An organization whose exemption application has been denied or revoked can always file a new one. But if it is denied or revoked because of a prohibited transaction, a new exemption application can't be filed before the taxable year following that in which notice of denial or revocation was issued. And a new exemption won't be granted before the beginning of the taxable year following that in which the new application is filed.¹

✓ *Illustration:* In the case of a calendar year organization, exemption is revoked in '65. New application may not be filed before '66. If it is filed in '66, the first year for which exemption may be granted is '67.

1. Proc. Rules § 601.201(n) (7) (vii).

§ 7969. Returns during exemption and after revocation. In general, exempt organizations must file annual information returns. But certain religious and charitable organizations are exempt from even this obligation.¹ This subject is more fully discussed at § 7956.

The filing of information returns by an organization that honestly believes itself to be

exempt starts the period of limitations on assessments and collection.²

But exempt organizations aren't excused from filing information or other returns concerning payments to employees and others.³

An organization whose exemption is revoked must file income tax returns. Such returns must include all income thereafter received or accrued even though derived from contracts issued or assets acquired before the exemption was revoked.⁴

Loss of its exemption doesn't affect the organization's accounting period. Unless the organization becomes taxable on the first day of its taxable year, it must file a short taxable year return beginning with the first day it is taxable and ending with the last day of that taxable year.⁵ The income for such a short year may not be arrived at by prorating the full year's income.⁶

1. Code Sec. 6033(a); Regs. § 1.6033-1(g) and (h).
2. Code Sec. 6501(r) (2).
3. Regs. § 1.6033-1(h) (3).
4. *Royal Highlanders*, 1 T.C. 184 (A), rev'd on other grounds 138 F. (2d) 240.
5. *Royal Highlanders*, 1 T.C. 184 (A), rev'd on other grounds 138 F. (2d) 240.
6. *Economy Savings & Loan Co.*, 5 T.C. 543 (NA), aff'd and rev'd on other issues 158 F. (2d) 472.

§ 7970. Prohibited Transactions.

Some organizations will be denied any exemption if they engage in so-called prohibited transactions. These are transactions with an organization from which its creator or a substantial contributor to it may benefit financially. Only real, not potential, prohibited transactions bar exemption.

§ 7971. Organizations affected. A requisite for exemption of an important group of organizations is that they don't engage in prohibited transactions. This rule applies to:

... Organizations in the religious, charitable, educational, literary, scientific, testing for public safety, and prevention of cruelty to children or animals category, *subject to important exceptions*, listed at § 7902.

... Employees' supplemental unemployment benefit trusts and qualified employee pension, profit sharing or stock bonus trusts, listed at § 7903.

The prohibited transaction rule doesn't apply to the large group of exempt organizations listed at § 7904.

§ 7972. What are prohibited transactions. The object of the prohibited transactions rule is to prevent the creator of, or a substantial contributor to, an exempt organization from directly or indirectly receiving financial benefit from dealings with the organization.

The prohibition applies to any transaction, between the organization and the creator or a substantial contributor to it or certain related persons, in which the exempt organization:

... Lends any part of its income or corpus without adequate security and reasonable interest.

... Pays any compensation in excess of a reasonable allowance for personal services actually rendered.

... Makes any part of its services available on a preferential basis.

... Makes any substantial purchase of securities or any other property for more than adequate consideration.

... Sells any substantial part of its securities or other property for less than an adequate consideration.

... Engages in any other transaction which results in substantial diversion of income or corpus.¹

The prohibition applies only when the person who is the other party to, and who re-