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LEADERS IN NONPROFIT LAW

# Obtaining and Retaining Tax-Exempt Status

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Primer on Advising Nonprofit Organizations  
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# Agenda

1. Overview of Tax-Exempt Status
2. Requirements for a 501(c)(3) Charity
3. Public Charity vs. Private Foundation
4. Applying for 501(c)(3) Status
5. Conclusion



# Overview of Tax-Exempt Status

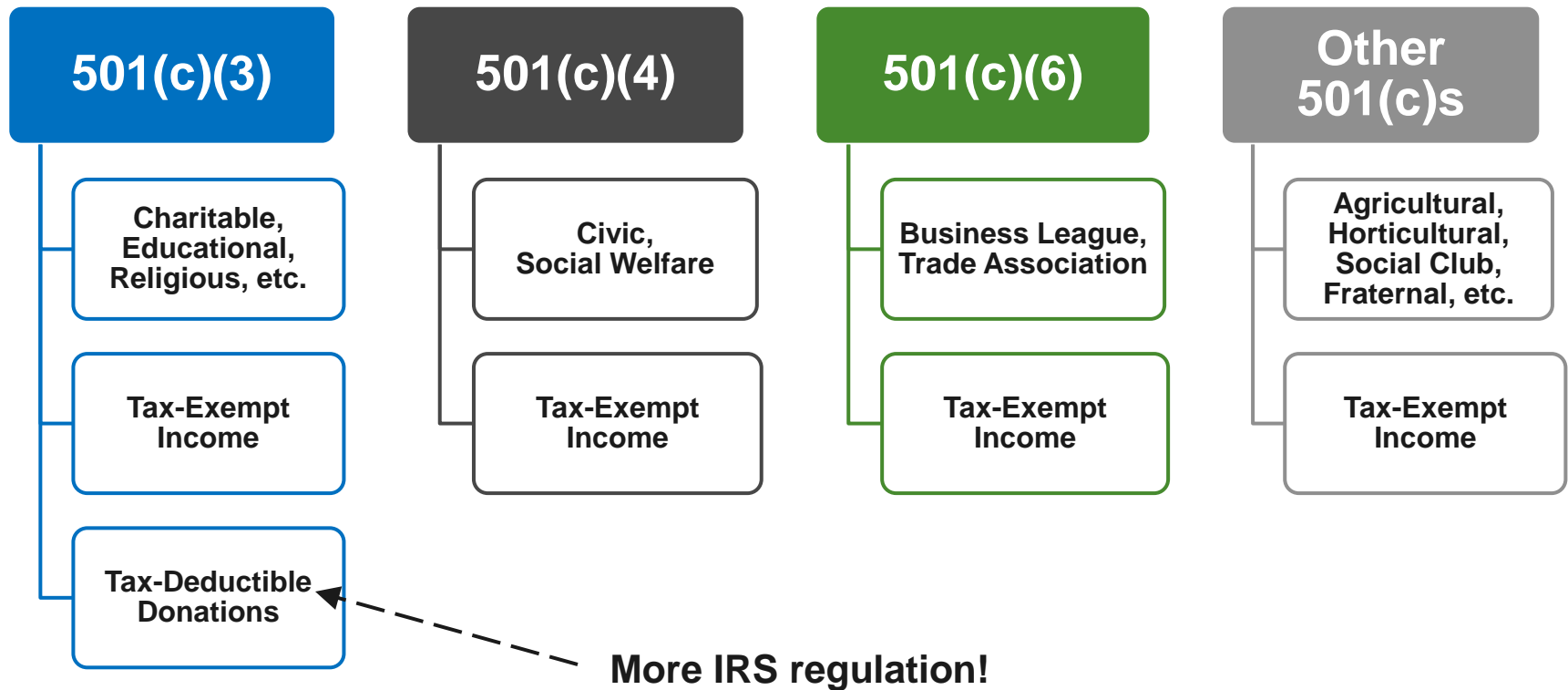


# Overview of Tax-Exempt Status

- **Source of exemption**
  - Section 501(a) and 501(c) provide exemption for organizations we'll discuss today
  - 29 different types under Section 501(c)!
  - State status in Colorado piggybacks on federal status



# Types of Tax-Exempt Organizations





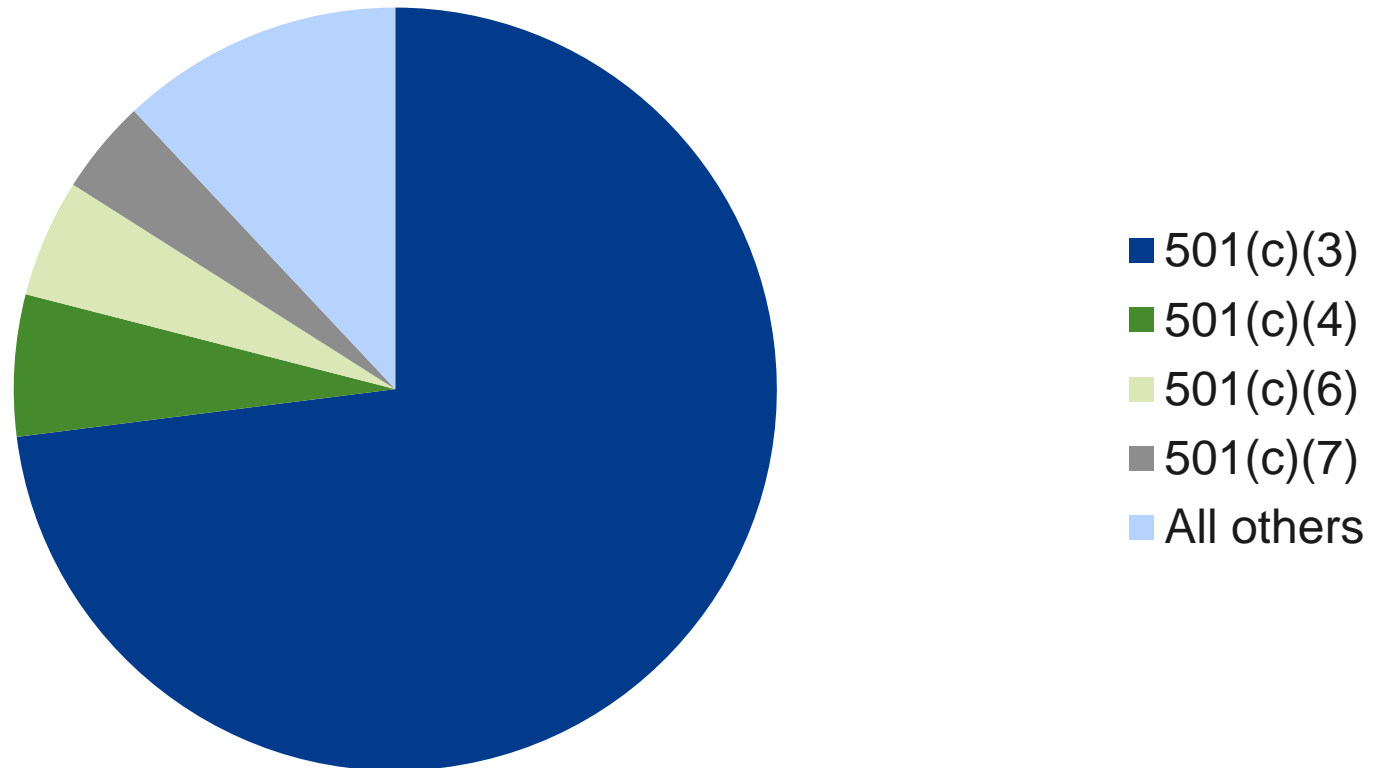
# Overview of Tax-Exempt Status

- **Other benefits of exemption**
  - Exemption from state and federal income tax
  - Other benefits depend on type of organization
    - Sales tax
    - Property tax
    - Postal privileges
    - Greater eligibility for grants
    - Tax deductible contributions (in limited circumstances)



# Overview of Tax-Exempt Status

## 501(c) Organizations

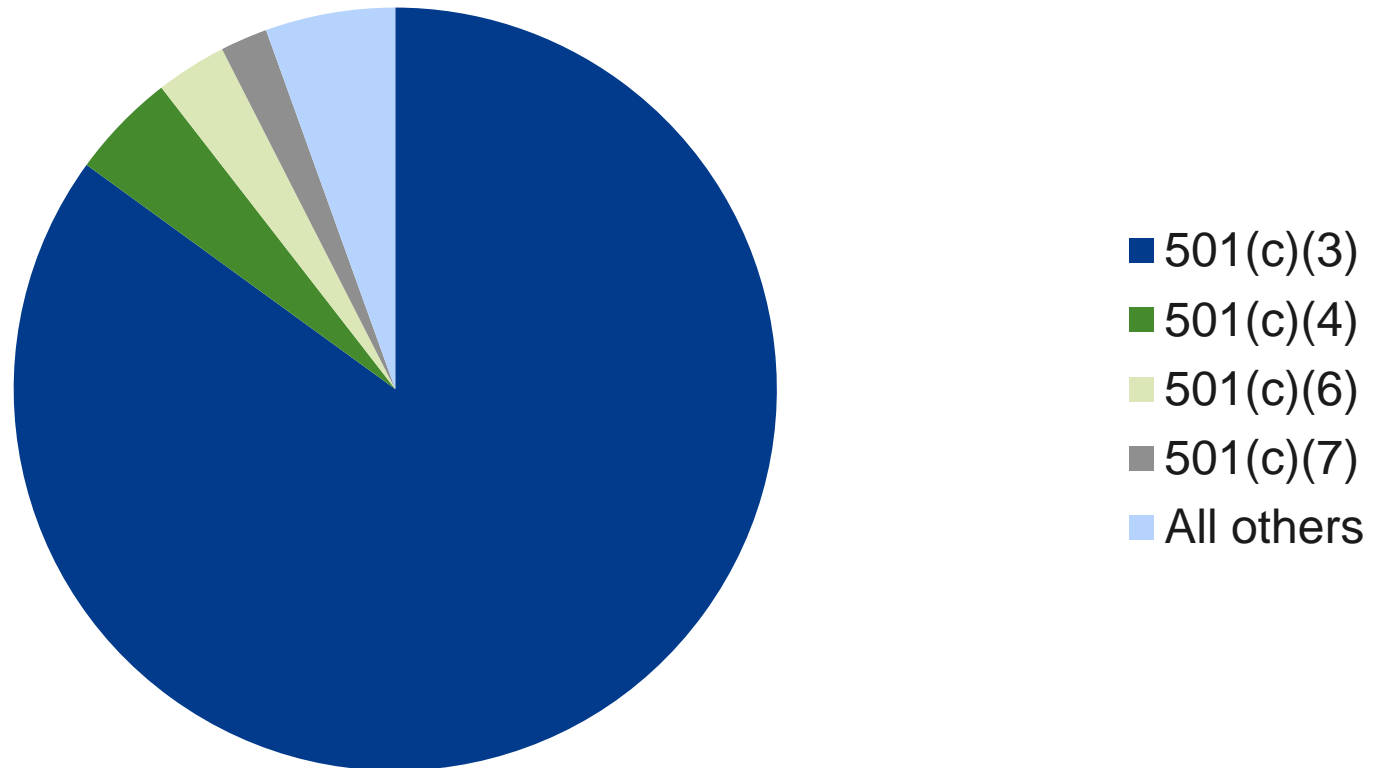


Source: 2013 IRS Data Book



# Overview of Tax-Exempt Status

## New 501(c) Applications



Source: 2013 IRS Data Book





# Today's Primary Focus:

**A nonprofit entity that is ...**

**Nonprofit  
Corporation**



**501(c)(3) Status**



**Public Charity  
Classification**



# Requirements for a 501(c)(3) Charity



# Requirements for a 501(c)(3) Charity

## ▪ Three main requirements

1. Must be organized and operated exclusively for 501(c)(3) purposes
2. No private inurement of income and assets to private individuals
3. No substantial lobbying and no political campaign activity



# Requirements for a 501(c)(3) Charity

## 1. **Organized and operated exclusively for 501(c)(3) purposes**

- Statute enumerates eight purposes under 501(c)(3)
- Charitable trust law provides overlay
  - Benefits flowing to charitable class (sufficiently broad and indefinite)
  - Limitations where public policy violated (e.g., violations of law, racial discrimination)



# Requirements for a 501(c)(3) Charity

## 1. **Organized and operated exclusively for 501(c)(3) purposes**

- Charitable
- Educational
- Religious
- Scientific
- Literary
- Prevention of cruelty to children or animals
- Fostering national/international sports competition
- Testing for public safety



# Requirements for a 501(c)(3) Charity

## 1. Organized and operated exclusively for 501(c)(3) purposes

- Organizational test requires certain provisions to be included in formation documents regarding purpose and dissolution
  - Purpose of exempt organization should be set out, and document should not expressly allow prohibited activities
  - Assets must be devoted exclusively to exempt purposes, so provide where assets go upon dissolution



# Requirements for a 501(c)(3) Charity

## 1. Organized and operated exclusively for 501(c)(3) purposes

- Operational test requires that the organization be operated “exclusively” for 501(c)(3) purposes, though regulations interpret “exclusively” as “primarily”
  - Unrelated business income taxation
  - Private benefit
  - Commerciality
  - Other non-exempt issues



# Requirements for a 501(c)(3) Charity

## 1. Organized and operated exclusively for 501(c)(3) purposes

- Any non-exempt activities must be insubstantial, and may result in unrelated business taxable income
  - Important exceptions include passive income, volunteer exception, donated goods exception, convenience exception
  - Monitor with caution activities at 15 percent level, and consider using subsidiary for activities approaching 30 percent
  - IRS Colleges and Universities Compliance Project shows focus on issue, which likely will play out in other types of nonprofits





# Requirements for a 501(c)(3) Charity

## 1. Organized and operated exclusively for 501(c)(3) purposes

- Benefit to a private party that is more than incidental violates the operational test (the “private benefit doctrine”)
  - Qualitative inquiry focuses on whether the benefit is necessary result of the activity benefiting public at large
  - Quantitative focuses on the amount being conferred



# Requirements for a 501(c)(3) Charity

## 1. Organized and operated exclusively for 501(c)(3) purposes

- Activity that is too commercial violates the operational test (the “commerciality doctrine”)
  - Charity can try to distinguish by not directly competing with for-profit; having reduced fees/sliding scale for low-income users; serving a “customer” base consisting of a charitable class; and relying to some extent on donations
  - This doctrine may come up more and more in social enterprise area



# Requirements for a 501(c)(3) Charity

## 2. No private inurement

- Translation: the impermissible use or payment of assets or income to an “insider”
  - Focus is on control or substantial influence over and relation to organization
  - Think founders, directors, officers, key employees, family members of the previous individuals, and certain related organizations



# Requirements for a 501(c)(3) Charity

## 2. No private inurement

- No “de minimis” private inurement
- Private inurement comes up in situations including compensation, sales, rentals, loans and other related party situations
- Manage by focusing on reasonableness and documentation

*Note:* many other exempt organizations (e.g., 501(c)(4)s and 501(c)(6)s) are subject to private inurement prohibition, as well



# Requirements for a 501(c)(3) Charity

## 2. No private inurement

- Traditionally, violation meant revocation of exempt status
- Excess benefit transaction/intermediate sanctions are another way for IRS to address private inurement
- Penalty taxes on disqualified person and sometimes organization manager
- Again, focus on reasonableness and documentation; use rebuttable presumption

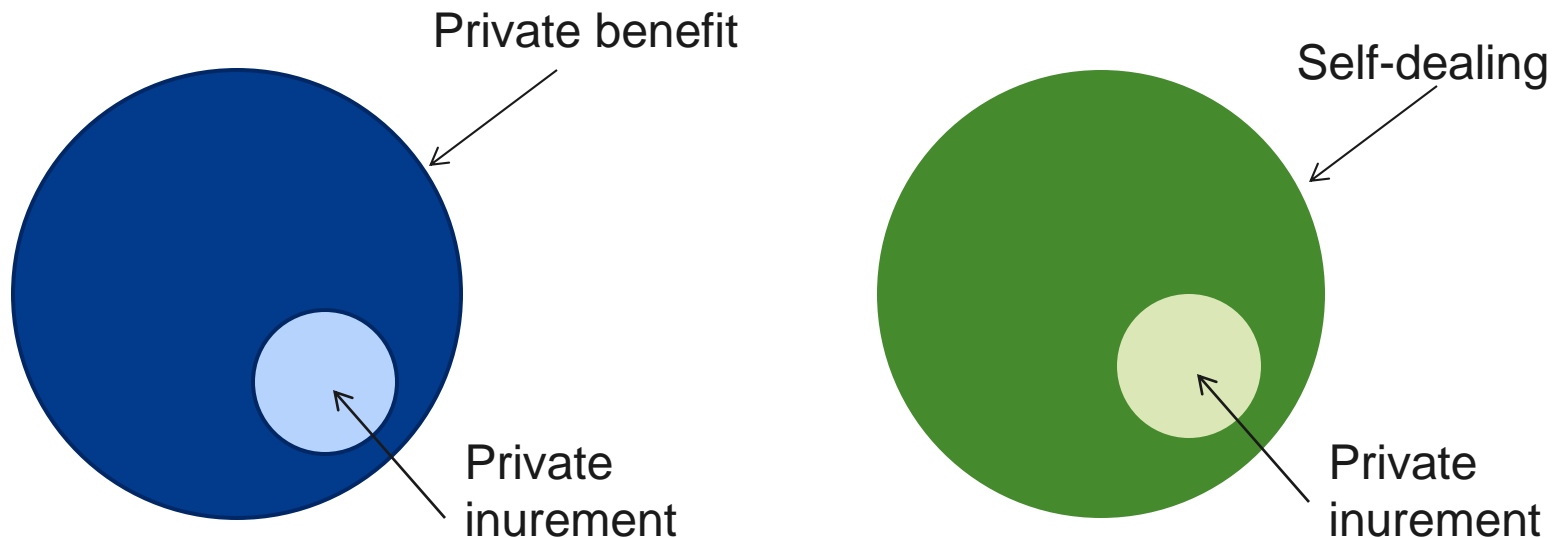
**Note:** Intermediate sanctions rules apply to 501(c)(4)s, as well, but not other exempt organizations like 501(c)(6)s



# Requirements for a 501(c)(3) Charity

## 2. No private inurement

- Separate concept from private benefit
- Separate requirement from private foundation self-dealing rules





# Requirements for a 501(c)(3) Charity

## 3. No substantial lobbying; no political campaign activity

- Private foundations cannot lobby at all
- Other charities must keep to an insubstantial amount
  - Facts-and circumstances
  - Expenditure test (501(h) election)



# Requirements for a 501(c)(3) Charity

## 3. No substantial lobbying; no political campaign activity

- Facts-and-circumstances test determined on case-by case basis
  - Less clarity
  - No safe harbor percentage





# Requirements for a 501(c)(3) Charity

## 3. No substantial lobbying; no political campaign activity

- Expenditure test (501(h) election) measures allowable lobbying as a percentage of overall expenditures
  - Organization must elect this test
  - Different allowable amounts for direct and grassroots lobbying



# Requirements for a 501(c)(3) Charity

## 3. No substantial lobbying; no political campaign activity

- Grants to grantees that lobby can still be OK if no earmarking
- Some express exceptions to lobbying definition:
  - Self-defense
  - Technical advice
  - Non-partisan analysis, study or research
  - Examinations of broad social, economic or similar problems
  - Some membership communications



# Requirements for a 501(c)(3) Charity

## 3. No substantial lobbying; no political campaign activity

- *Compare to non-501(c)(3) organizations*
  - Other exempt organizations can lobby to unlimited degree if related to exempt purpose
  - Consider whether a 501(c)(4) is a better fit
  - Consider tandem or affiliated structure



# Requirements for a 501(c)(3) Charity

## 3. No substantial lobbying; no political campaign activity

- Concern here is with partisan activity
- But non-partisan activity can be permissible
  - Form or debates
  - Public policy statements
  - Voter registration (additional requirements for private foundations)
  - Educational materials about candidates



# Requirements for a 501(c)(3) Charity

## 3. No substantial lobbying; no political campaign activity

- *Compare to non-501(c)(3) organizations*
  - Other exempt organizations can participate in some partisan activity, so long as it is not their primary purpose—BUT consider new proposed regulations for 501(c)(4) organizations, which redefine political activity in that context
  - Current challenges around allowable amount, identity of donors
  - Again, consider tandem or affiliated structure



# Public Charity vs. Private Foundation



# Legal Framework for Nonprofit Tax Status

Nonprofit Organizations

Tax-Exempt Organizations  
§ 501(c)

Charitable Organizations  
§ 501(c)(3)

## Public Charities

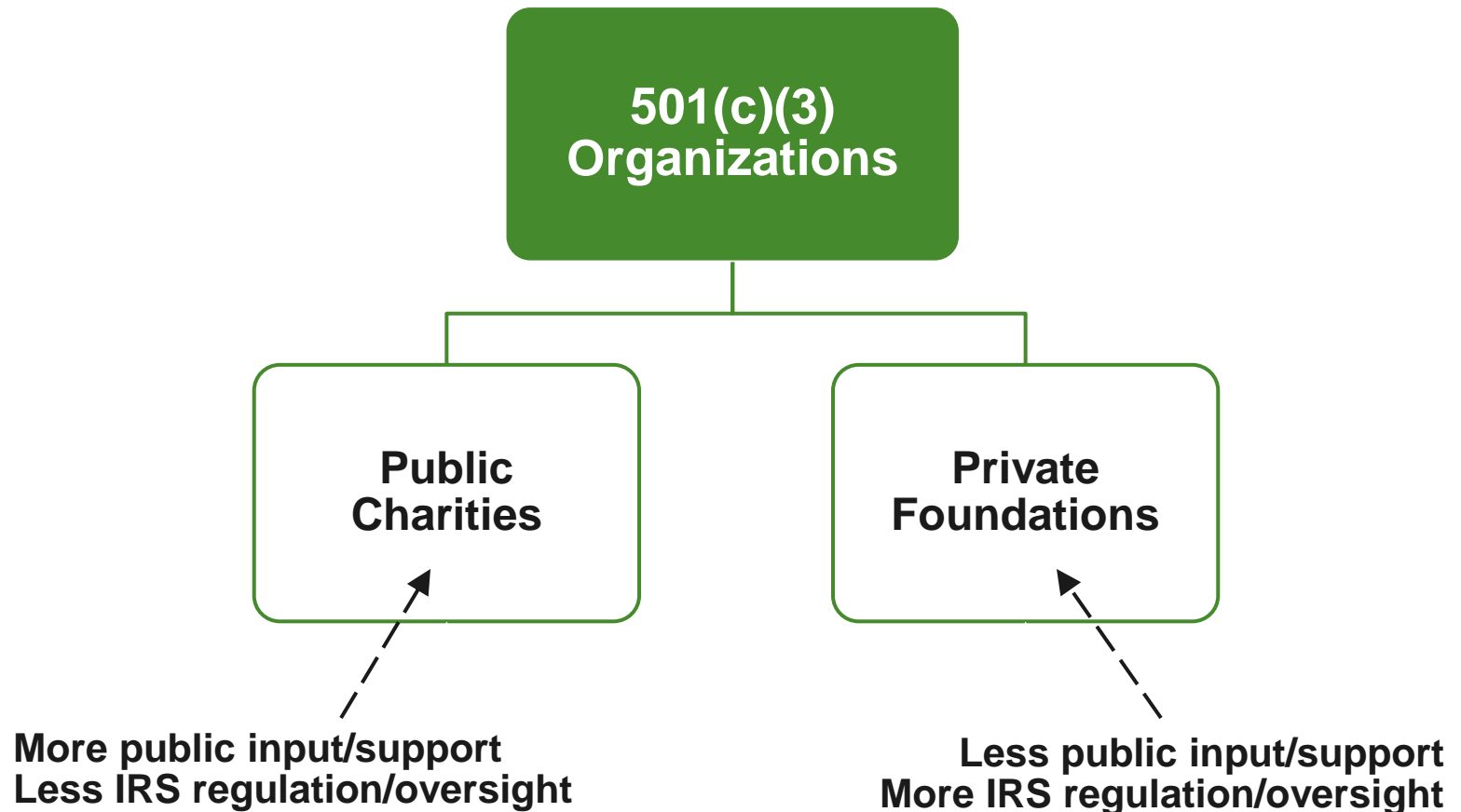
- Traditional Charities  
§ 509(a)(1)/170(b)(1)(A)
- “Gross Receipts” Charities  
§ 509(a)(2)
- Supporting Organizations § 509(a)(3)

## Private Foundations

- Non-operating Foundations
- Operating Foundations
- Pass-thru Foundations
- Pooled Income Funds
- Split Interest Trusts



# Types of 501(c)(3) Organizations







# Public Charity vs. Private Foundation

- **Types of public charities:**
  - Institutional charities
    - Hospitals, schools, churches
    - Governmental organizations
  - Publicly supported charities
    - 509(a)(1)/170(b)(1)(A)(vi) test (primarily gifts, grants, contributions)
    - 509(a)(2) test (includes exempt function income)
  - Supporting organizations
    - Type I: parent/subsidiary relationship
    - Type II: brother/sister relationship
    - Type III: looser relationship; can be functionally or non-functionally integrated



# Public Charity vs. Private Foundation

- **Types of private foundations:**
  - Non-operating foundations (i.e., grantmakers)
  - Operating foundations
    - Carry out their own programs, similar to public charity
    - Must meet certain distribution requirements and other tests
  - Others
    - (pooled income fund, pass-thru foundation, non-exempt charitable trusts/split income trust)



# Public Charity vs. Private Foundation

- **Public charity status comes with benefits:**
  - Reduced IRS regulation
  - Preferential treatment for deductibility
  - Easier options for changing status



# Public Charity vs. Private Foundation

- **Private foundations have additional restrictions and requirements:**
  - Net investment income excise tax
  - Self-dealing restrictions
  - Mandatory payout requirements
  - Restrictions on amount of business holdings
  - Restrictions around jeopardizing investments
  - Restrictions on taxable expenditures
  - Tougher to transition status



# Applying for 501(c)(3) Status



# Applying for 501(c)(3) Status

- **Form 1023 is filed for recognition of status, and must describe the following:**
  - Planned activities
  - Leadership
  - Fundraising plans
  - Operational budgets
  - Compensation plan
  - International activity
  - Grantmaking



# Applying for 501(c)(3) Status

- **Exceptions from filing:**
  - Churches, interchurch organizations, conventions or associations of churches and integrated auxiliaries
  - Organizations with annual gross receipts of \$5,000 or below
  - Organizations that are subordinates under group exemption

*Note:* organizations may wish to apply for various reasons



# Applying for 501(c)(3) Status

- **Filing Fee required**
- **Time of Filing:**
  - If filed within 27 months of formation, status retroactive to formation
  - If filed later than that, need to establish reasonable cause and lack of prejudice to government
  - Recent change makes it harder to qualify as 501(c)(4) in interim





# Applying for 501(c)(3) Status

- ***Compare to non-501(c)(3) organizations:***
  - Form 1024 shorter, less detailed
  - Non-501(c)(3)s don't technically need to apply for recognition of status



# Conclusion



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