Obtaining and Retaining Tax-Exempt Status

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Primer on Advising Nonprofit Organizations | May 4, 2016
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

- **501(c)(3)**
  - Charitable, Educational, Religious, etc.
  - Tax-Exempt Income
  - Tax-Deductible Donations

- **501(c)(4)**
  - Civic, Social Welfare
  - Tax-Exempt Income

- **501(c)(6)**
  - Business League, Trade Association
  - Tax-Exempt Income

- **Other 501(c)s**
  - Agricultural, Horticultural, Social Club, Fraternal, etc.
  - Tax-Exempt Income

More IRS regulation!
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
Overview of Tax-Exempt Status

501(c) Organizations

Source: 2015 IRS Data Book
Overview of Tax-Exempt Status

New 501(c) Applications

Source: 2015 IRS Data Book
Today’s Primary Focus

A nonprofit entity that is …

Nonprofit Corporation + 501(c)(3) Status + Public Charity Classification
Requirements for 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 or 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
     - 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 document should 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
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, donated goods, convenience
     - Monitor with caution activities at 15 percent level, and consider using subsidiary for activities nearing 30 percent
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 competing with for profit; having reduced fees/sliding scale for low-income users; serving a customer base consisting of charitable class; and relying on donations to some extent
   - Doctrine coming up in social enterprise area
Requirements for a 501(c)(3) Charity

2. No private inurement

- Translation: 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
   - Comes up in situations like compensation approval, sales, rentals, loans and other related-party deals
   - Manage by focusing on reasonableness, documentation

*Note: many other exempts also subject to this restriction*
Requirements for a 501(c)(3) Charity

2. No private inurement
   - Traditionally, violation meant revocation of status
   - Excess benefit transaction rules are alternative
   - Penalty taxes on individuals
   - Focus on reasonableness, documentation, rebuttable presumption

Note: 501(c)(4)s also subject to excess benefit transaction rules
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 insubstantial amount
     - Facts-and-circumstances test
     - Expenditure test, aka 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 measurement
Requirements for a 501(c)(3) Charity

3. No substantial **lobbying**; no political campaign activity
   - Expenditure test 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 lobbying grantees 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
   - Concern here is partisan activity
   - But non-partisan activity can be OK
     - Forums or debates
     - Public policy statements
     - Voter registration
     - Educational materials about all candidates
Requirements for a 501(c)(3) Charity

3. No substantial lobbying; no political campaign activity
   - Compare to other exempt organizations:
     - Non-501(c)(3) organizations can participate in some partisan activity, so long as it is not their primary purpose—this is an area in transition as IRS works to better define this
     - Current challenges around allowable amount, donor identity
     - Again, consider tandem or affiliated structure
Public Charity vs. Private Foundation
# 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

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Types of 501(c)(3) Organizations

- **Public Charities**
  - More public input/support
  - Less IRS regulation/oversight

- **Private Foundations**
  - Less public input/support
  - More IRS regulation/oversight
Public Charity vs. Private Foundation

- **Types of public charities**
  - Institutional charities
    - Hospitals, schools, churches, governmental organizations
  - Publicly supported charities
    - Test for primary support from gifts, grants and contributions
    - Test for primary support from exempt function income
  - Supporting organizations
    - Type I, II or III
Public Charity vs. Private Foundation

- Types of private foundations
  - Non-operating foundations (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 business holdings
  - Restrictions on jeopardizing investments
  - Restrictions on taxable expenditures
Applying for 501(c)(3) Status
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 less
  - Organizations that are part of group exemption

*Note: Organizations may wish to apply nonetheless*
Applying for 501(c)(3) Status

- **Streamlined Form 1023-EZ:**
  - Projected gross receipts of $50,000 or less for next three years
  - Actual gross receipts of $50,000 or less for past three years
  - Total assets at or under $250,000
  - Limited to certain types of organizations / activities
  - Form require attestations re activities, documents
Applying for 501(c)(3) Status

- Miscellaneous
  - Filing fee required
  - If filed within 27 months of formation, exempt status retroactive to formation date
  - If filed later than 27 months, exempt status retroactive to postmark date unless organization can establish reasonable cause
Applying for 501(c)(3) Status

- Compare to non-501(c)(3) organizations
  - Form 1024 shorter, less detailed
  - Non-501(c)(3)s can be self-declared and do not need to apply for recognition of status
  - Recent law changes does require 501(c)(4)s to notify IRS about their intent to operate as a 501(c)(4) within 60 days of formation
Conclusion