Understanding and Establishing Nonprofit Tax-Exempt Organizations: An American Example

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I. Overview of Tax-Exempt Organizations

A. History and Rationale

This article explains the rules limiting activities of charitable and social welfare organizations and trade associations or business leagues in the U.S., all of which are tax-exempt, nonprofit organizations described in section 501(c).[1]

Section 501(c) has antecedents back to the beginnings of the U.S. tax laws, but the conceptual rationale for why those specific categories of organizations should be afforded special tax treatment has never been articulated clearly.

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1 Unless otherwise indicated, all section references are to sections of the Internal Revenue Code of 1986, as amended. For detail *see generally* Bruce R. Hopkins, Legal Guide To Starting and Managing a Nonprofit Organization, 2D Ed. (1993); Bruce R. Hopkins, the Law of Tax-Exempt Organizations Planning Guide: Strategies and Commentaries (2004); Michael I. Sanders, Joint Ventures Involving Tax-Exempt Organizations (2000); the Legislative Labyrinth: A Map For Not-For-Profits, Walter P. Pidgeon Ed., (2001); Thomas K. Hyatt, Bruce R. Hopkins, the Law of Tax-Exempt Healthcare Organizations (2001); Marion R. Fremont-Smith, Governing Nonprofit Organizations: Federal and State Law and Regulation (2004).

When the first corporate income tax was imposed in 1894 (later held unconstitutional), Congress exempted from taxation nonprofit charitable, religious, and educational organizations, fraternal beneficiary societies, certain mutual savings banks, and certain mutual insurance companies. The Internal Revenue Code of 1913, enacted after the Sixteenth Amendment was ratified, contained similar provisions.

The tax exemption for charitable organizations has an even older historical basis.[2] According to McGovern, from the time of the Roman Empire, religious and other charitable organizations have been exempt from taxation.

In the United States, legislators have been willing to exempt from taxation additional categories of organizations that provide certain perceived benefits to society. Legislators have also exempted certain types of organizations from taxation at the behest of special interests. For example, the "business league" exemption contained in what is now section 501(c)(6) was included in the Tariff Act of 1913 at the urging of the U.S. chamber of Commerce.[3]

The legislative histories of these provisions are cryptic, at best, regarding the economic or other policy theory justifying tax-exempt status.[4] Because of statutory restrictions, nonprofit organizations are not permitted to distribute net earnings to shareholders or other insiders. Theoretically, these restrictions ensure that all "profits" are used for purposes that have been identified, through legislation, as resulting in public good.

B. Major Categories

For purposes of this article, the major categories of organizations exempt from federal income taxation are:

1. The "charitable" organization described in section 501(c)(3). That section applies to "[c]orporations, and any community chest, fund or

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2 *See generally* James J. McGovern, The Exemption Provisions of Subchapter F, 29 Tax Law, 523 (1976).

3 *Id.*

4 From a managerial perspective, *see generally* Thomas Wolf And Barbara Carter, Managing A Nonprofit Organization In The Twenty,- First Century (1999); see also and Peter F. Drucker, Managing The Non-Profit Organization; Principles And Practices (1992); Harvard Business Review on Nonprofits (Harvard Business Review Paperback Series 1999).

foundation, organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment) or for the prevention of cruelty to children or animals."[5]

Charitable organizations generally are not subject to income tax. Charities are, however, taxed on their unrelated business income, which consists (with certain exceptions) of income from a trade or business regularly carried on and not substantially related to the organization's exempt functions.[6] Contributions to charitable organizations generally are tax deductible, within certain limitations, by the door.[7]

The Internal Revenue Services (IRS), in Revenue Ruling 67-325, 1967-2 C.B. 113, stated that charitable activities for purpose of federal tax law "do not reflect any novel or specialized tax concept of charitable purposes, ... [but] should be interpreted as favoring only those purposes which are recognized as charitable in the generally accepted legal sense."

The concept of "charitable," for tax purposes, therefore includes (but is not limited to) relief of poverty by assisting the poor, distressed and underprivileged; advancement of religion; advancement of education and science; performance of government functions and lessening of the burdens of government; and promotion of health. However, an organization that normally would be considered charitable or educational will not be granted tax-exempt status if its activities are contrary to "public policy." Thus, to qualify as tax exempt, an organization's purposes and activities may not be illegal or "so at odds with the common community conscience as to undermine any public benefit that might otherwise be conferred."[8] Moreover, as discussed in more detail below, at Part I(D), a (c)(3) organization is not permitted to "carry[] on propaganda, or otherwise attempt[] to influence legislation," except to a limited extent. At the same time, a (c)(3) organization may not participate to any extent in the political process by attempting, directly or indirectly, to influence elections.

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5 For convenience, we will refer to all of these as "charitable organizations" or "(c)(3) organizations."

6 Given the focus of this article, the rules relating to the trade or business activities of tax-exempt organizations are not likely to be particularly relevant.

7 Section 170 of the Code.

8 Bob Jones University v. United States, 461 U.S. 574, 575 (1983) (school with certain racially discriminatory policies not eligible for exemption as (c)(3) organization).

Additionally, the organization's net income may not inure, in whole or in part, to the benefit of private shareholders or individuals.

A (c)(3) organization must satisfy both an organizational and operational test. The organizational test is described in Part II below. Under the operational test, an organization is considered to operate exclusively for exempt purposes only if it engages primarily in activities that accomplish one or more of its exempt purposes.[9] As discussed further below, an organization will fail the operational test if more than an insubstantial part of its activities is not in furtherance of an exempt purpose or if its net earnings inure in whole or in part to the benefit of insiders or others.[10]

Organizations exempt from taxation under section 501(c)(3) are further divided into two categories – public charities and private foundations, with private foundations being subject to a complex set of additional rules under the Internal Revenue Code.[11]

2. Other tax-exempt organizations:

a. An organization may qualify as exempt from taxation under section 501(c)(4) if it is operated "exclusively for the promotion of social welfare." Moreover, to qualify as a section 501(c)(4) organization, "no part of the net earnings of... [the organization may] inure [] to the benefit of any private shareholder or individual."

A section 501(c)(4) organization must serve "the common good and general welfare of the people of the community." If the community served is too narrow, the organization impermissibly serves private interests

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9 Treas. Reg. § 1.501(c)(3)-1(c).

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11 This paper does not address in any detail the rules governing the activities of private foundations. As a general proposition, a charitable organization will be classified as a private foundation if it has limited sources of funding. Because private foundations do not rely on fund-raising from the general public, they are not subjected, to the same extent as public charities, to public influence on their activities. Congress, therefore, has imposed more onerous operating restrictions and reporting requirements on private foundations, with additional excise taxes being imposed if such rules are violated. Among other things, private foundations and their managers are subject to excise taxes if they engage in any lobbying or self-dealing transactions. If a public charity receives a grant or donation from a private foundation and such funds are "earmarked" for noncharitable purposes, such as lobbying or electioneering, the private foundation and its management may be subjected to excise penalty taxes.

and will not qualify as tax exempt. As stated by the Fourth Circuit Court of Appeals, "Congress [in enacting section 501(c)(4)] believed that an organization cannot serve social welfare if it denies its benefit to the general public. Implicitly, Congress recognized that a true 'community' functions within a broader national fabric. Service to such a community thereby furthers the national interest by expanding potential, by opening opportunities to all citizens who may someday find themselves within the bounds of that particular community."[12] Unlike a charitable organization, a social welfare organization may attempt to influence legislation as its primary or even exclusive activity.[13]

A section 501(c)(4) organization may also engage in political campaigning in pursuit of its exempt purposes, as long as such campaigning does not constitute the organization's "principal" activity.[14]

A donor may not deduct contributions to section 501(c)(4) organizations as a charitable deduction. To the extent such contributions qualify as ordinary and necessary business expenses of the donor, however, the donor can deduct the contribution (except to some extent)

Historically, social welfare organizations are exempt from taxation to encourage voluntary and community activism, in an effort to care for public needs. Examples of section 501(c)(4) organizations are the NAACP, the Sierra Club, National Abortions Rights Action League and AARP.

b. Section 501(c)(6) exempts from federal income taxation "[b]usiness leagues... not organized for profit or no part of the net earnings of which inures to the benefit of any private shareholder or individual." This is the provision under which trade associations are exempt.

Treasury Regulations section 1.501(c)(6)-1 provides that "[a] business league is an association of persons having some common interest, the purpose of which is to promote such common interest.... It is an organization of the same general class a chamber of commerce or a board of

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12 Flat Top Lake Ass'n, Inc. v. Unites States, 868 F.2d 108, 111-12 (4th Cir. 1989) (homeowners association for a specific residential community does not further social welfare).

13 Rev. Rul.68-656, 1968-2 C.B. 216 (organization that attempts to influence legislation which is germane to its exempt purposes qualifies as a social welfare organization).

14 Rev. Rul.81-95, 1981-1 C.B. 332 (an organization primarily engaged in the promotion of social welfare may participate in lawful political campaign activities without adversely affecting its exempt status).

trade. Thus, its activities should be directed to the improvements of business conditions of one or more lines of business as distinguished from the performance of particular services for individual persons."

Examples of (c)(6) organizations are the United States Chamber of Commerce, American Bar Association, American Medical Association, Tobacco Institute and Tobacco Distributors Association.

The public policy rationale for exempting business leagues from taxation is to promote the welfare of the business and industrial community on a theory that a healthy business climate advances the public welfare. A (c)(6) organization may engage in lobbying to any extent as long as such activities are germane to its business league purposes. Such an organization may also engage political activities designed to influence the outcome of elections, if the political activities are not its primary activity.

Contributions to a section 501(c)(6) organization are not tax deductible as charitable contributions. However, membership dues paid to a section 501(c)(6) business league may be deductible to members as business expenses, except to some extent, the section 501 (c)(6) organization engages in lobbying activities.

Section 501(c)(4) and (c)(6) organizations generally are not subject to tax on income, except to the extent such income is from an unrelated trade or business. In general, state tax laws incorporate categories of exempt organizations that are similar in all significant respects to section 501(c)(3) charities, section 501(c)(4) social welfare/advocacy groups, and section 501(c)(6) business leagues.

II. Organizing Nonprofit or Tax-Exempt Organizations

A. Establishing an Entity

A tax-exempt organization must be an entity established under state law. Generally, a tax-exempt entity is organized as a corporation, but it may also be set up as an association, a trust or other entity. An individual cannot be tax exempt. Nor, it seems, would a partnership or any limited liability company treated as a partnership qualify.

In the case of an (c)(3) organization, the governing instruments must comply with the organizational test, which must be met as a condition to exemption:

a. An entity is organized exclusively for (c)(3) purposes only if its articles of organization (i.e., its articles of incorporation, articles of association, trust instrument, or other written instruments by which it is created) limit its activities to furthering such exempt purposes.[15]

b. An entity is not considered organized exclusively for exempt charitable purposes if its articles of organization expressly authorize it to devote more than an insubstantial part of its activities to attempting to influence legislation by propaganda or otherwise, or directly or indirectly participating in, or intervening in, any political campaign.[16]

c. An entity is not organized exclusively for exempt charitable purposes unless its assets are dedicated to an exempt purpose. An organization's assets will not be considered dedicated to an exempt purpose if, upon dissolution, the assets would, by reason of a provision in the organization's articles of organization or by operation of law, be distributed to the organization's members or founders or to an entity that will not use the assets to further exempt purposes.[17]

d. In addition, the organization may not be authorized to engage, more than to an insubstantial degree, in activities that are not in furtherance of one or more exempt purposes.[18]

e. If the articles of organization authorize non-exempt activities to more than an insubstantial degree, the fact that an organization's actual operations have been exclusively for exempt purposes is not sufficient.[19]

State law requirements will govern the establishment of the entity. To establish a corporation, for example, articles of incorporation generally must be filed with the Secretary of State. Most states have separate statutory rules for organizing not-for-profit corporations.

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15 Treas. Reg. § 1.501(c)(3)-1(b).

16 Treas. Reg. § 1.501(c)(3)-1(b)(3).

17 Treas. Reg. § 1.501(c)(3)-1(b)(4).

18 Treas. Reg. § 1.501(c)(3)-1(b)(1)(iii).

19 Treas. Reg. § 1.501(c)(3)-1(b)(1)(iv).

B. Obtaining Tax-Exempt Status

To qualify as a (c)(3) organization at the federal level, an organization must file an application with the IRS and obtain recognition of its tax-exempt status from the IRS. (Form 1023) If an organization files a Form 1023 seeking recognition as a (c)(3) organization within 27 months after the end of the month in which it was formed and if the IRS approves the organization's application, the effective date of the organization's (c)(3) status will be retroactive to the date the organization was organized.

Technically, to be exempt from federal income taxation under section 501(c)(4) or section 501(c)(6), an organization must satisfy the statutory requirements, but is not required to obtain formal recognition from the IRS. However, without formal recognition from the IRS, an organization's tax-exempt status is uncertain. Many social welfare advocacy groups and business leagues, therefore, seek IRS recognition of their tax-exempt status. (Form 1024)

After obtaining recognition of its federal tax-exempt status, an organization generally seeks tax-exempt status at the state (and possibly local) level.

Not-for-profit organizations may be exempt from state income, property, and sales and use taxes. Generally, the standards for obtaining an exemption from state income tax are the same as at the federal level. States may impose certain additional requirements for tax exemption. For example, to qualify as a charitable organization for state purposes, the focus of the organization's activities may need to be within the state or jurisdiction from which tax-exempt status is sought. This is the rule in the District of Columbia.[20]

If an organization does not qualify as a tax-exempt charity under state law because the focus of its eleemosynary activities is not within the state, the organization may be reclassified as a social welfare organization that is exempt from state taxation but is not eligible to receive contributions that are deductible by the donor for state tax purposes. Any change in the organization's tax-exempt status under state law,

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20 However, the Supreme Court recently declared unconstitutional a Maine law that deprived charitable institutions of otherwise available property tax exemptions if the charities were operated mainly for the benefit of out-of-state residents. Camps Newfound/Owatonna, Inc. v. Town of Harrison, U.S.,117 S. Ct. 1590 (May 19, 1997)..

because of the organization's failure to sufficiently focus its activities within the state, will have no effect on the organization's exempt status on the federal level.

C. Ongoing Organizational Requirements

To operate in a particular state, a tax-exempt organization may need to satisfy certain registration requirements and reporting obligations. In its state of incorporation, the organization will likely to be required to file an annual report, providing basic information such as the organization's address, as well as the names and address of its officers and directors.

An organization may need to file similar reports in every state in which it does business. An organization may also be required to register to solicit funds in a particular state. Tax-exempt organizations—with some exceptions for certain types of organizations (e.g., churches) or small organizations—are required to file annual federal tax information returns. Sec. 6033.[21]

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21 The following types of exempt organizations do not have to file Form 990 or Form 990-EZ with the IRS:

A church, an interchurch organization, a convention or association of churches or an integrated auxiliary of a church (such as a men's or women's organizations, religious school, mission society, or youth group). Section 6033(a)(2)(A)(i). A school below college level affiliated with a church or operated by a religious order. A private foundation (which is required to file an annual Form 990-PF). A stock bonus, pension, or profit-sharing trust that qualifies under section 401. An organization whose annual gross receipts are normally $25,000 or less. A tax-exempt organization's unrelated business income, if any, must be reported to the IRS on a Form 990-T. Organizations will likely be required to file state tax returns as well. Many states accept copies of the Federal From 990 in satisfaction of their filling requirements.