

Forming, Maintaining, and Governing a Section 501(c)(3) Organization

Presented by
Sharon Weinberg Nokes, Esq.
Washington Area Lawyers for the Arts

Goals/Roadmap

- To understand the benefits, responsibilities, opportunities, and limitations of operating a section 501(c)(3) organization.
- To understand the alternatives to forming a section 501(c)(3) organization.
- To understand the processes for forming a nonprofit entity (state filings) and preparing an application for tax-exempt status (IRS filings).

PART I

What is a 501(c)(3)?

501(c)(3) Overview

- **Rationale:**
 - Government supports charitable work with favorable tax treatment.
 - Must prepare application and request exemption from the IRS.
- **Key Features of a 501(c)(3):**
 - Once approved by the IRS, a 501(c)(3) is exempt from paying federal corporate income tax.
 - *Not* personal income tax.
 - *Not* automatically exempt from state income, property, sales, or other taxes (these must be applied for separately—states generally follow IRS, but higher standards may apply for state exemptions).
 - Once approved by the IRS, contributions to a section 501(c)(3) are tax-deductible to the donor.

“Nonprofit” ≠ “Tax-Exempt”

- **“Tax exempt”/501(c)(3)** is a federal classification; must meet requirements set out in the Internal Revenue Code.
- **“Nonprofit”** is a state law classification; must meet the requirements of the state nonprofit laws (e.g., the D.C. Nonprofit Corporation Act).
- **The Two Are Distinct.** Many tax-exempt organizations are formed as nonprofit corporations (which provide limited liability for fiduciaries). But being organized as a state law nonprofit does not cause the organization to be exempt from federal income tax. 501(c)(3) status must be applied for and granted by the IRS.

Types of 501(c)(3) Organizations

- **Public Charities (preferred status in most cases)**
 - Statutory categories, e.g., churches, schools, hospitals.
 - The rest must satisfy a “public support test.”
- **Private Foundations (default classification)**
 - Organizations that do not meet the definition of “public charity” and/or are funded by a small group of private donors.
 - More heavily regulated by the IRS; subject to specific tax rules.

Qualifying as Exempt Under 501(c)(3)

Must be:

- Organized exclusively for exempt purposes (“**Organizational Test**”).
- Operated exclusively for exempt purposes (“**Operational Test**”).

How exclusive is “exclusive”?

- Insubstantial nonexempt activities OK (<5%?)

Organizational Test

At a minimum, a 501(c)(3)'s organizing documents (e.g., its Articles of Incorporation, filed with the state/District) must affirmatively:

- limit the organization's purposes to 1 or more "exempt purposes";
 - Charitable (includes promotion of the arts)
 - Educational
 - Religious
 - Scientific
 - Literary
- prohibit more than an insubstantial amount of nonexempt activities;
- prohibit all political activities and private inurement; and
- provide that, upon dissolution, all of the organization's assets will be distributed to charity.

Operational Test

- **In addition to stating the 501(c)(3) requirements in its organizing documents, the organization must actually function (activities and governance) in accordance with those requirements. E.g.:**
 - No private inurement;
 - May not benefit private parties more than incidentally;
 - No substantial lobbying (charities only);
 - No political activities; and
 - Unrelated business activities should be limited in scope.

Private Inurement and Excess Benefit

- **Private Inurement:**

- 501(c)(3)s have no “owners”
- This is reflected in the tax code, which says: “no part of the net earnings” of a 501(c)(3) may inure to the benefit of a “shareholder” or insider.
- Any payment above FMV to an insider can cost exempt status.

- **Excess Benefit (in less egregious cases):**

- 25% tax on certain insiders (called “disqualified persons”) for “excess benefit transactions”, 200% if not corrected
- Disqualified persons include CEO, CFO, board, others with substantial influence (e.g., in control of a major department).
- Also their family members and 35%-owned businesses
- Variable/revenue-based compensation concerns

Private Benefit

A 501(c)(3) organization must operate for the benefit of the general public and must avoid activities that will benefit the private interest of any individual or organization (including, but not limited to insiders) more than incidentally.

Lobbying and Political Activities

- **No** funds/resources may be used to support (or oppose) a candidate for public office.
- Resources used to influence legislation must be **strictly limited**.
 - Substantial Part Test (default rule): If a substantial part (likely 3-5% or more) of your organization's activities consist of propaganda or otherwise attempting to influence legislation, exemption may be denied/revoked.
 - 501(h) Election (opt-in rule): A 501(c)(3) charity may elect to replace the "substantial part test" with sliding scale "expenditure test." Election is made by filing Form 5768 to make the 501(h) election.
 - Note: Executive agency officials (e.g., at the NEA/DCCA) are not "legislators"; agency rules are not "legislation."

Limits on Commercial Activities

- **Unrelated Business Income:**
 - Income from a trade or business that is regularly carried on, and not substantially related to the charitable, educational, or other purpose that is the basis of the organization's exemption.
 - Subject to "unrelated business income tax " (UBIT) at regular corporate rates.
 - "Fragmentation rule" applies.
 - Rationale: Intended "to eliminate a source of unfair competition" between exempt and non-exempt organizations that carry out the same activities by "placing [them] upon the same tax basis."
- **Common UBIT situations:**
 - Web/print advertising
 - Sharing donor lists with third parties
 - Renting out facilities for private events

Limits on Commercial Activities

- **Notes:**

- There are exclusions from unrelated business income that may reduce tax liability (e.g., for investment income, royalties, and certain rents).
- Advertising is per se unrelated; “qualified” corporate sponsorships are related.
- If unrelated business activities are a “substantial portion” of an exempt organization’s operations, its public charity status or, worst case, its tax-exempt status, may be impacted.
- There is no fixed percentage or test defining “substantial.”
- Complex rules apply; if you have an issue in this area, consult with counsel.

PART II

Do I really want (or need) a 501(c)(3)?

Benefits of 501(c)(3) Status

- Exemption from federal income tax.
- State and local property tax exemptions generally follow; other tax exemptions may apply as well.
- Diverse funding opportunities.
 - Easier to obtain grants from foundations/government/corporations.
 - Eligible for tax-deductible contributions from the public.
 - May generate tax-free revenues from exempt activities and certain investments.
 - Also may generate some taxable revenue through nonexempt activities.
- May facilitate use of volunteers in ways that are prohibited in the for-profit sector.
- Reduced postal rates (by application).
- Exemption from Federal unemployment tax.

Burdens of 501(c)(3) Status

- Requires greater transparency/public accountability/scrutiny.
 - Form 990 information return is publicly-available.
 - Exemption application must be made available upon request.
- Greater compliance/reporting burdens, particularly for organizations that lobby or fundraise in multiple states.
- Activities must do more than accomplish “good.” They must primarily fulfill exempt/charitable purposes.
 - *Compare:* Art museum vs. artist cooperative that displays works by emerging artists and pays a commission to artists.
 - Relationships between the organization and its insiders/private parties must be closely monitored (and will be reviewed by the IRS).
 - Limits on activities that have a “commercial” hue.

Alternatives to 501(c)(3) Status

- If you have a plan, but are not quite ready to launch, consider becoming a “project” of an existing charity under a **fiscal sponsorship**.
 - A formal/contractual arrangement in which a 501(c)(3) public charity “sponsors” (incubates) a project that lacks exempt status (usually for a fee). This alternative to starting a charity allows you to seek grants and solicit tax-deductible donations under your sponsor's exempt status.
 - Donations are treated/reported as donations to the sponsoring charity. IRS requires the sponsor to have full discretion and control over the funds (not a conduit); IRS holds the sponsor legally responsible for ensuring that the funds are used to further exempt purposes.
 - E.g., Fractured Atlas

Alternatives to 501(c)(3) Status

- If grant-making is your primary objective, consider establishing a **donor-advised fund** maintained by a “sponsoring charity”.
- If your activities do not fit well within the restrictions of 501(c)(3), consider a **different type of 501(c) organization**.
 - E.g., section 501(c)(4) “social welfare organization”; section 501(c)(6) “business league.
 - Note, however, that limitations on inurement, private benefit, UBIT still apply.

Alternatives to 501(c)(3) Status

- If too much commercial activity, but low projected profits, consider a **taxable non-profit corporation** (or a for-profit corporation with a socially-beneficial mission).
 - Note that converting from taxable to tax-exempt is possible, but generates tax liability upon conversion.
 - Also note that private foundation grants, while admittedly more scarce, are available.

Should I Create a 501(c)(3)?

Questions to Ask

- Is my organization ready to launch, or should I partner with an existing 501(c)(3) “incubator”?
- Can my plan be effectively executed by a 501(c)(3) charity?
 - Are projected programs charitable, educational, etc., in nature?
 - Will I be conducting the programs directly (or funding another organization to do so)?
 - Who is executing the programs? Will they be paid (and, if so, how and how much)?
 - Where will the \$\$ come from?
- Am I prepared to shoulder the administrative/compliance/governance responsibilities of running an organization?

PART III

How do I get my 501(c)(3) up and running?

Launching Your 501(c)(3) Roadmap

1. Choose a name
2. Select a Board of Directors
3. Initial Board meeting
4. Form an entity under state law (usually a nonprofit corporation), adopt bylaws
5. Obtain an employer identification number from the IRS (Form SS-4)
6. **Apply for tax-exempt status (Form 1023 or Form 1023-EZ)**
7. Complete state business and tax registrations in states of incorporation and operation (e.g., where you have offices)
8. Obtain determination letter from the IRS
9. Apply for state tax exemptions (if not done previously)
10. Register to solicit charitable contributions (as applicable/if not done already), see www.multistatefiling.org for more information

Launching Your 501(c)(3) Required IRS Filings

Application for an Employer Identification Number (Form SS-4)

- May be accomplished by filing a paper form, or by filing online at <http://www.irs.gov/Businesses/Small-Businesses-&Self-Employed/Apply-for-an-Employer-Identification-Number-%28EIN%29-Online>.
- Note that you will need the name and SSN of a “responsible party.”

Application for Recognition of Tax-Exempt Status (Form 1023)

- Must be filed within 27 months of date of incorporation, in order to obtain exempt status retroactive to the date of incorporation

Launching Your 501(c)(3) Required IRS Filings

Form 1023 (cont'd)

- New short-form “1023-EZ” released in 2014 year to simplify the application process for organizations that are smaller and have less complex operations.
- For those organizations that are ineligible to use the short form, the most substantive materials required by the IRS are:
 - Statement of activities detailing the organization’s proposed activities.
 - Estimated or actual budgets for three years.
 - Additional information re: “special” aspects of your operations (e.g., international activities, development/use of IP, fundraising activities).
- Special schedules must be filed in certain circumstances, including “successor organizations,” scholarship/fellowship providers, churches, schools, and organizations filing more than 27 months after formation.
- Long-form application also can be filed online via an “Interactive Form 1023,” at <http://www.stayexempt.irs.gov/StartingOut/InteractiveForm1023Application.aspx>

Simplified Application: 1023-EZ

New “short form” exemption application for entities that satisfy the following requirements, among others:

- Annual gross receipts did not exceed \$50k in any of the past 3 years;
- Projected annual gross receipts are not expected to exceed \$50k in any of the next 3 years;
- Total assets have FMV of less than \$250k;
- Not organized as an LLC;
- Not a successor to a for-profit entity;
- Not a church, school, hospital, supporting organization, operating foundation, etc.;
- Does not maintain donor-advised funds;
- Does not participate in joint ventures with non-501(c)(3)s.

Form 1023-EZ

- Organizations that meet these requirements may file the Form 1023-EZ, a 3-page form that will essentially allow the applicant to self-certify that it meets the requirements for tax-exempt status (and attain speedy approval, without follow-up from the IRS).
- It is important to note that the IRS's stated plan is to "check in" with these organizations several years after approval is granted (e.g., through compliance checks or limited-scope audits), to ensure that they are operating in compliance with section 501(c)(3). Thus, it remains critical to understand the requirements for maintaining tax-exempt status and conduct their operations accordingly.
- \$275 user (application) fee.

Launching Your 501(c)(3) Purpose of The “Long Form” 1023

- Through its Form 1023, the organization must demonstrate to the IRS:
 - That it satisfies the “organizational” test for 501(c)(3) status;
 - That it satisfies the “operational test” for 501(c)(3) status; and
 - That it is projected to satisfy a “public support test” (if seeking public charity status).
- Each section of the application is intended to elicit information that will help the IRS make these determinations.

Note: Your determination letter only covers the information provided to the IRS in the 1023 and any follow-up submissions requested by the IRS. Be complete, candid, and thorough when completing these submissions, to ensure maximum protection.

Long Form 1023 Summarized

- **Part I – Identification of Applicant**
 - Basic contact information and website (if any).
 - Must include date of incorporation/formation.
- **Part II – Organizational Structure**
 - Must attach copy of Articles & Board-approved Bylaws.
- **Part III – Required Provisions in Organizing Docs**
 - Must cite (page/¶) the purposes & dissolution clauses.
- **Part IV – Narrative Description of Your Activities**
 - Must include past, present, and planned activities.

Long Form 1023 Summarized

- **Part V – Compensation & Other Financial Arrangements with Officers, Directors, Trustees, Employees, & Independent Contractors**
 - Must identify directors/officers and their compensation (any economic benefit).
 - Must identify five top-compensated contractors/employees who will earn more than \$50k.
 - Must disclose business/family relationships among these people.
 - Must disclose existence of and transactions with entities 35% controlled by these people.
 - Must disclose details re: the nature/process for setting the compensation of, and approving transactions with, these people (and provide copy of the organization's conflict of-interest policy).

Long Form 1023 Summarized

- **Part VI – Members/Individuals/Organizations that Receive Benefits**
 - Questions relate to goods, services, and funds you provide to individuals/organizations as part of your activities.
- **Part VII – Your History**
 - Must disclose status as a “successor organization” (and file Schedule G).

Long Form 1023 Summarized

- **Part VIII – Your Specific Activities**

- Must describe certain activities, e.g., (a) politicking; (b) lobbying; (c) gaming; (d) fundraising; (e) affiliations with governmental units; (f) use of volunteers; (g) joint ventures; (h) childcare activities; (i) development, ownership, and distribution of IP; (j) plans to accept certain types of contributions (e.g., real property, artwork, intellectual property); (k) foreign activities; (l) grants/loans/distributions to domestic or foreign organizations; (m) grants to individuals.
- Must describe “close connections” to other organizations.

Long Form 1023 Summarized

- **Part IX – Financial Data**

- If in existence <5 years, complete the statement of revenue/expenses for each year in existence and provide projections of likely revenues and expenses based on a reasonable good faith estimate for a total of (i) 3 years if you have not completed one tax year, or (ii) 4 years if you have completed one tax year.
- Balance Sheet for most recent (or current) tax year.

Long Form 1023 Summarized

- **Part X – Public Charity Status**

- Indicate whether you are a private foundation or public charity – and, if the latter, what type of charity.

- **Part XI – User Fee (filing fee)**

- \$400 if revenues do not (or are not projected to) exceed \$10k annually over a 4-year period.
- \$850 if revenues do (or are projected to) exceed \$10k annually over a 4-year period.

Long Form 1023 Summarized

- **Schedules A through H (as applicable)**
 - A. Churches
 - B. Schools, Colleges, Universities
 - C. Hospitals, Medical Research Organizations
 - D. Supporting Organizations
 - E. Organizations Not Filing Form 1023 Within 27 Months of Formation
 - F. Homes for the Elderly/Handicapped, Low-Income Housing
 - G. Successors to Other Organizations
 - H. Organizations Providing Scholarships, Educational Loans, or Other Educational Grants

What Happens Next?

- **1023-EZ:** Expect a response within 90 days (usually sooner).
- **Long Form 1023:**
 - IRS sends a letter confirming that it received the application within a few weeks.
 - Expect to hear from the IRS within 180 days. If you do not hear anything, your application may have been placed in a queue with other applications requiring “development” (review by an IRS Tax Law Specialist/attorney).
- **Note:** In exceptional circumstances (for example a large grant that is contingent on exempt status by a certain date), it may be possible to “expedite” the application. *Inability to solicit deductible contributions is not an “exceptional circumstance” justifying expedited review.*

Questions?