Obtaining and Maintaining §501(c)(3) Status

By Weijing Wu and Chengcheng Zhang

Overview

Obtaining tax-exempt status under §501(c)(3) of the Internal Revenue Code is financially beneficial for a nonprofit organization. Not only will it be exempt from federal income taxes at the entity level, its donors will also benefit from tax deduction on their federal income tax. In order to become a §501(c)(3) entity, a nonprofit organization needs to satisfy state law on corporate formation, state tax law requirements and federal tax law requirements. To become a valid corporation under state law, a nonprofit needs to choose a state of domicile and comply with its law on incorporation accordingly. However, suppose a nonprofit wants to incorporate in Delaware but also be qualified to do business in Iowa. It will be subject to the same biennial reporting requirements as a domestic Iowa corporation in addition to ongoing Delaware filing obligations. As for satisfying state tax exemption laws, some states grant tax-exempt status automatically if an organization satisfies the federal requirements. This QuickCounsel explains the federal law requirements.

Advancing a tax-exempt purpose

To satisfy the requirements for a §501(c)(3) organization, a nonprofit must first organize and operate for one or more of the enumerated tax-exempt purposes: religious, charitable, scientific, literary, or educational purposes, testing for public safety, fostering national or international amateur sports competitions, and the prevention of cruelty to children or animals. The first prong of this purpose requirement, in the form of an organizational test, looks to the specific language of the governing documents (the articles of incorporation) to see if the organization is empowered to run charitably. To satisfy the second prong of the requirement, an operational test, a nonprofit must show to the IRS that its day-to-day operation indeed "primarily and substantially" advances its tax-exempt purpose, as shown in the founding documents. (Note: Although §501(c)(3) states that an organization must organize and operate "exclusively" for a tax-exempt purpose, the Treasury Regulations explained that "exclusively" really means "primarily" or "substantially" here. Treas. Reg. §1.501(c)(3)-1(c)(1).)

Operating for a public benefit

The law gives a nonprofit organization tax benefits and its contributors charitable deduction because the organization is serving "a public rather than a private interest." Treas. Reg. §1.5011(c)(3)-1(d)(1)(ii). A private-interest-oriented purpose is not a tax-exempt purpose, and the presence of a "substantial" private benefit will destroy the exemption status of a §501(c)(3) organization, regardless of its other existing tax-exempt purposes or activities. The crucial inquiry is thus what counts as "substantial." In American Campaign Academy v. Commissioner, 92 TC 1053 (1989), it was defined as "non-incidental benefits conferred on disinterested persons that serve private interests." At its most basic level, the public benefit requirement forbids private inurement. That is, no part of the net earnings of a nonprofit inures to the benefit of any private shareholder or individual. The Treasury Regulations, in return, define "private shareholder or individual" as any "person having a personal or private interest in the activities of the organization." Treas. Reg. §1.501(a)-1(c). This definition means that not only are the nonprofit organization's employees and directors forbidden from private inurement, other persons who exercise control over the organization also fall into the prohibited category, even when they do not hold any official title.
There are two types of private inurement one must refrain from in order to keep the organization's tax-exempt status. Interested persons must first refrain from direct inurement, in the form of direct transactions with the organization. This means, for instance, that directors and officers must not issue dividend-like distributions, or enter into below-fair-market-value deals resulting in excessive economic benefit flowing from the organization to private individuals. Second, interested persons must refrain from more subtle forms of private inurement. For example, corporate opportunities must be made available to the organization to consider before anyone could appropriate and exploit as his or her own. Subtle forms of private inurement cannot be exhaustively listed and are intimately related to the fiduciary duties of directors and officers. They may include assignments of income, compensation arrangements, sale or exchanges of property, commissions, rental arrangements, gifts with retained interests, and contracts to provide goods or services to the nonprofit organization.

Finally, the IRS may impose excise taxes on excess benefit transactions between a nonprofit and the disqualified persons. Disqualified persons are those in a position to exercise substantial influence over the nonprofit's affairs at any time during the five-year period before the excess benefit occurred. 26 U.S.C.A. §4958. The benchmark as to what is "excessive" is the fair market value. The disqualified person who benefited is liable for an excise tax equal to 25% of the benefit received, and an additional tax equal to 200% of the benefit is imposed if the person fails to pay the amount. As a result, although this intermediate sanction does not result in the revocation of a nonprofit's tax-exempt status, it does incur significant costs to its directors, managers or other relevant disqualified persons.

Lobbying, but within limits

A nonprofit organization seeking §501(c)(3) status must not expend substantial part of resources attempting to influence legislation. This lobbying limitation rests on the theory that the government subsidizes nonprofits in the form of tax privileges. Substantial attempts to influence legislation or affect a political campaign should not be subsidized, since congressional policy requires that the United States Treasury be neutral in political affairs. While it is a belief held by many nonprofit leaders that any engagement in lobbying would strip the organization of its tax-exempt status, it is far from the truth. Nonprofit organizations with such a misbelief may cripple themselves in conducting mission-maximizing activities, given the far-reaching effects of changed legislation.

The IRS denies or revokes tax-exempt status under §501(c)(3) only if a "substantial part of the activities … is carrying on propaganda, or otherwise attempting, to influence legislation." What counts as "substantial," however, can involve difficult factual assessment. While there is judicial guidance by way of a "Substantial Part" test accompanied by various factors to consider, a nonprofit still has to make a factual judgment at its own peril. Fortunately, there is an alternative to the Substantial Part assessment, by which a nonprofit can avoid a factual determination altogether. The mechanism to do so is an expenditure test, available if a nonprofit makes a §501(h) election. The "H election," passed by the Congress in 1976, provides a bright-line mathematical formula to guide nonprofits as to how much can be spent on influencing legislation. This seems a better option not only because of the legal certainty it brings about in comparison to the Substantial Part test, but also because the allowable amount for many organizations under the H election is high and rarely exceeded, and because it defines lobbying activities rather narrowly. Furthermore, a nonprofit could easily take advantage of this election by filing out a Form 5768, with little administrative hassle.

Not an action organization

A nonprofit organization must not, directly or indirectly, "participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of (or in opposition to) any candidate for public office." Unlike the lobbying limitation, the prohibition on involvement with political campaigns is absolute. While expressly endorsing or opposing a political candidate, working on behalf of a candidate, or campaigning against a candidate falls squarely within the scope of the prohibition, indirect or nonverbal messages signaling approval or disapproval also risk losing tax-exempt status. IRS Ruling 2007-41 gives some good guidance on how to avoid falling foul of the prohibition. For instance, nonprofit leaders must not make partisan comments in their official capacity. To avoid confusion regarding
the capacity in which a nonprofit leader speaks, he or she should state explicitly that he or she was not speaking as the representative of the organization. Another risky situation involves candidate appearances at nonprofit organization's events. While a nonprofit may invite political candidates to speak at its events, organizers should consider a range of factors to determine if the activity may amount to the nonprofit's participation or intervention in a political campaign in the eyes of an objective audience. Those factors include whether the organization extended an equal opportunity to other political candidates seeking the same office, whether the organization's communication regarding the candidate's attendance is politically neutral, and whether any political fundraising occurs. If a single candidate is invited to speak in a non-candidate capacity, then nonprofit leaders should make sure that, looking at the totality of the circumstances, the candidate indeed appeared to be participating in his or her individual capacity. In theory, a nonprofit may take position on public policy issues, including issues that divide candidates in an election for public office. It should nonetheless act cautiously. It may still risk losing its §501(c)(3) status in the absence of an explicit message to an audience to vote for or against a specific candidate, if its public-policy-position-taking implicitly send messages favoring or opposing a candidate as indicated by the overall facts and circumstances.

Conclusion

The primary instrument a nonprofit organization uses in order to obtain §501(c)(3) status is Form 1023 (Application for Recognition of Exemption), filed within 27 months from the end of the month in which the nonprofit was formed. Satisfying the requirements of §501(c)(3) is, of course, merely the beginning of legal compliance for nonprofit organizations. Accountability rules from federal, state, and local governments, as well as industry self-regulations, together hold nonprofit organizations accountable to their missions.

Additional Resources

Sample Form & Policy (2014): Model Nonprofit Gift Acceptance Policy

QuickCounsel (2013): Awarding Employee Bonuses in a Nonprofit Organization

Sample Form & Policy (2011): Steps to Forming a Nonprofit and Obtaining IRS Exempt Status


Quick Reference (2007): Political Activity Doctrine