Learn how to satisfy legal requirements when starting a nonprofit organization

HOW TO START A NONPROFIT ORGANIZATION (LEGALLY)

A NONPROFIT LAW PRIMER

BRUCE R. HOPKINS

Second Edition

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Everything you need to know
to start a nonprofit organization –
in satisfaction of law requirements.

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Introduction

This book reflects my experiences over 50 years of law practice in the nonprofit law arena. I have formed and nurtured hundreds of nonprofit organizations. With this book, I am sharing my knowledge and insights into this process with you.

When contemplating the formation of a nonprofit organization, one fundamental fact should be kept in mind at all times: starting a nonprofit entity is not that much different from starting a for-profit company. Both types of endeavors should be taken seriously. They require planning and money. There is a tendency in some quarters to dismiss the significance of undertakings if they are (merely) nonprofit. That is a big mistake. Establishing a nonprofit organization can be a glorious and exciting experience – but there are difficult decisions to be made and there is hard work to be done.

Nonprofit organizations are among our nation's greatest resources. The U.S. nonprofit sector is a marvel. It constitutes over two million wonderful, helping, and caring organizations. There is always need and room for more, including yours. I hope this book helps.

Chapter 1: A Law Primer

You do not have to be a lawyer to set up a nonprofit, tax-exempt organization. But you are better off hiring (a competent) one if you can. If you do it yourself, this chapter will give you insights as to the bodies of law with which you must be familiar. (Or, use this law primer as a test of your lawyer's knowledge.)

Primary Purpose Rule

The primary purpose rule is one of the fundamental bases for determination of the appropriate category of tax exemption (if any) for a nonprofit organization. This principle is formally explicated by use, in the description of exempt organizations categories, of words such as *exclusively* or *substantially*, which, in federal tax law parlance, are usually synonymous with *primarily*.

The primary purpose rule thus is that, to be tax-exempt, the purpose or purposes of a nonprofit organization must primarily be accomplishment of one or more exempt purposes. The U.S. Supreme Court stated the matter in the negative: The "presence of a single [nonexempt] purpose, if substantial in nature, will destroy the exemption regardless of the number or importance of truly [exempt] purposes." The primary purpose rule is also used to determine the appropriate category of exemption for an organization.

Public Policy Doctrine

The public policy doctrine, as applied in the context of the law of tax-exempt organizations, states that an organization cannot be exempt as a charitable entity, even if it satisfies statutory law, if it is operating in a manner that is contrary to federal public policy. This doctrine, created by courts, is a judicial branch overlay of the law created by the legislative branch. Whether a public policy has been violated is a determination for the IRS, then perhaps a court, to make.

Perhaps the earliest statement of this doctrine was authored in 1867, when a state court opined that "[g]ifts for purposes prohibited by or opposed to the existing laws [today, including laws other than tax laws] cannot be upheld as charitable, even if for objects which would otherwise be deemed such." Ten years later, the U.S. Supreme Court wrote that a "charitable use, where neither law nor public policy forbids, may be applied to almost any thing that ends to promote the well-doing and well-being of social man." The Court invoked the doctrine in the context of the business expense deduction, stating that an expense is not "necessary" to operation of a business if allowance of a tax deduction would "frustrate sharply defined national or state policies proscribing particular types of conduct, evidenced by some governmental declaration thereof."

From a tax-exempt organizations' standpoint, the most important development in connection with the public policy doctrine occurred when the Supreme Court bluntly stated that the purpose of a charitable entity "may not be illegal or violate established public policy." It was written that "[h]istory buttresses logic to make clear that, to warrant [tax] exemption under § 501(c)(3), an institution must . . . demonstrably serve and be in harmony with the public interest" and not have a purpose that is "so at odds with the common community conscience as to undermine any public benefit that might otherwise be conferred." The Court added that "determinations of public benefit and public policy are sensitive matters with serious implications for the institutions affected" and that a "declaration that a given institution is not 'charitable' should be made only where there can be no doubt that the activity involved is contrary to a fundamental public policy."

Organizational Test

In a general fashion, all categories of tax-exempt organizations are subject to an organizational test and an operational test. These concepts are most developed in the case of exempt charitable organizations. If an organization fails to meet either test, it cannot qualify for exemption from federal income taxation as a charitable entity. The federal tax regulations barely provide for an organizational test for other categories of exempt regulations. This type of a test is occasionally referenced in IRS private letter rulings.

The organizational test focuses on two elements. One is the entity's statement of purposes. An organization is organized exclusively for one or more tax-exempt, charitable purposes only if its articles of organization limit its purposes to one or more exempt purposes and do not empower it to engage, other than as an insubstantial part of its activities, in activities that are not in furtherance of one or more exempt purposes. Additional requirements are imposed with respect to the governing instruments of supporting organizations and private foundations (see Chapter 4).

The other element of the organizational test is the requirement of a dissolution clause. An organization is not organized exclusively for one or more exempt charitable purposes unless its assets are dedicated to an exempt purpose. An organization's assets are so dedicated if, on dissolution, the assets would, by reason of a provision in the organization's articles of organization or by operation of law, be distributed to one or more other organizations for one or more exempt purposes, to the federal government, or to a state or local government, or would be distributed by a court to another exempt charitable organization to be used in a manner that, in the judgment of the court, will best accomplish the purpose or purposes for which the dissolved entity was organized. Most other categories of exempt organizations are not subject to any federal tax law dissolution requirements.

It is a common practice to include in a charitable organization's articles of organization provisions reflecting compliance with other requirements of the federal tax law, such as the doctrine of private inurement, the limitations as to allowable legislative activities, and the prohibition on political campaign activity (see below). These provisions are not, however, required.

Operational Test

The operational test focuses on how a nonprofit organization functions in relation to the applicable requirements for tax-exempt status. Thus, in a generic sense, every type of exempt organization is subject to an operational test. The most developed of the operational tests is the one pertaining to charitable organizations.

An organization, to qualify as a tax-exempt charitable entity, is regarded as operated exclusively for one or more exempt purposes only if it engages primarily in activities that accomplish one or more of its exempt purposes. An organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose. This test looks to the purposes the organization advances by means of its activities.

Action Organizations

An organization is not operated exclusively for one or more exempt charitable purposes if it is an action organization.

An organization is an *action organization* if a substantial part of its activities is attempting to influence legislation. For this purpose, an organization is regarded as attempting to influence legislation if the organization contacts, or urges the public to contact, members of a legislative body for the purpose of proposing, supporting, or opposing legislation or if it advocates the adoption or rejection of legislation. An organization is also an action organization if it participates or intervenes, directly or indirectly, in a political campaign on behalf of or in opposition to a candidate for public office.

An organization is an action organization if it has these characteristics: (1) Its main or primary objective or objectives may be obtained only by the enactment or repeal of legislative or a defeat of proposed legislation, and (2) it advocates or campaigns for the attainment of this main or primary objective or objectives as distinguished from engaging in nonpartisan analysis, study, or research, and making the results available to the public.

State Action Doctrine

The operations of nonprofit organizations, being private entities, are usually not subject to constitutional law principles. These principles, embedded in the U.S. Constitution and made applicable to the states by the Fourteenth Amendment, include free speech rights, due process, and equal protection of the law. They apply to actions of governments (the state). Yet the concept of state action and responsibility adheres to what a court termed “state participation through any arrangement, management, funds, or property”; this includes nonprofit organizations when they undertake activities that have a close nexus with a government – *state action*.

The distinction between state action and private operations sometimes is not clear; as the U.S. Supreme Court observed, it is called on from time to time to “plot a line” between the two, noting that the fashioning and application of a precise formula for recognition of state responsibility is an “impossible task.” The placement of this line can cause activities of an ostensibly private tax-exempt organization to be tested against constitutional law principles as if the entity were a state agency or an integral part of a state. The general standard, according to the Court, is that state action may be found if there is such a “close nexus between the State and the challenged action” that seemingly private behavior “may be fairly treated as that of the State itself.”

The most notable case, involving a nonprofit organization, where the Supreme Court found state action involved an athletic association that regulated interscholastic sport among the public and private high schools in a state. The association concluded that a school violated a recruiting rule and placed the school's athletic program on probation, declared its teams ineligible to compete in playoffs for two years, and imposed a fine. The Court held that this association was subject to constitutional law principles (due process) by application of the state action doctrine. It wrote: "The nominally private character of the [a]ssociation is overborne by the pervasive entwinement of public institutions and public officials in its composition and workings, and there is no substantial reason to claim unfairness in applying constitutional standards to it."

The U.S. Constitution, in the Fifth and Fourteenth Amendments, prohibits racial discrimination by government and government-supported private institutions. In general, private organizations (such as social clubs and fraternal groups) may lawfully discriminate, absent applicability of the state action doctrine by which government is deemed to have sufficiently supported or encouraged discrimination as to amount to a constitutional law violation (or a transgression of the public policy doctrine).

Doctrine of Private Inurement

The doctrine of private inurement is one of the most important sets of rules constituting the law of tax-exempt organizations. As noted, it is the fundamental defining principle of law distinguishing nonprofit organizations from for-profit organizations. This doctrine also is a statutory criterion for federal income tax exemption for nearly all categories of exempt organizations.

The oddly phrased and thoroughly antiquated language of the private inurement doctrine requires that the tax-exempt organization be organized and operated so that "no part of . . . [its] net earnings . . . inures to the benefit of any private shareholder or individual." The contemporary meaning of this statutory language is barely reflected in its literal form and transcends the over-100-yeat formulation. What the doctrine means today is that none of the income or assets of an exempt organization subject to the doctrine may be permitted to directly or indirectly unduly benefit an individual or other person (including an entity) who has a close relationship with the organization, where he, she, or it is in a position to, or actually does, exercise a significant degree of control over the organization.

The case law teaches that the private inurement doctrine is broad and wide-ranging. The rules concerning excess benefit transactions (see below) have brought some exactitude to the doctrine. Further, the rules as to self-dealing involving private foundations continue to bring examples of private inurement transactions (see Chapter 4).

The doctrine of private inurement does not prohibit transactions or arrangements between a tax-exempt organization subject to the doctrine and those who have a close relationship with it. Thus, as is the case with the excess benefit transactions rules and generally the doctrine of private benefit, the private inurement doctrine requires that these transactions be tested against a standard of reasonableness. This standard calls for an approximately equal exchange of benefits between the parties.

A potential private inurement transaction or arrangement is one that is between a tax-exempt organization that is subject to the doctrine and a person (or persons) who has a special, close relationship with the organization. To put a name to the latter, the federal tax law appropriated the term *insider* from the federal securities laws. Generally, an *insider* is an individual who has a unique relationship with the exempt organization involved, by which that individual can cause application of the organization's funds or assets for the private benefit of the individual by reason of the individual's exercise of control or influence over, or being in a position to exercise that control or influence over, the organization. Insiders include an organization's trustees, directors, officers, key employees, members of the family of these individuals, and entities controlled by them.

The concept of the private inurement transaction has many manifestations. The most common instance of private inurement is excessive (or unreasonable) compensation. Whether an amount of compensation is reasonable is a question of fact. The basic standard, which has long been in the federal tax law, is that reasonable compensation is that amount as would ordinarily be paid for like services by like enterprises under like circumstances. A multifactor test is usually used to determine reasonable compensation.

The other principal forms of private inurement involve rental arrangements, lending arrangements, sales of assets, capital improvements, equity distributions, assumptions of liability, provision of employee benefits, a variety of tax avoidance schemes, the rendering of services, and business referral operations. Again, transactions and arrangements in these contexts are tested against the standard of reasonableness.

The IRS remains of the view that there is no such thing as incidental private inurement. The agency, however, may elect to apply the intermediate sanctions penalties against the insider rather than revoke tax-exempt status. In that sense – private inurement that does not lead to loss of exemption – there can be incidental private inurement.

Doctrine of Private Benefit

An organization cannot qualify as a tax-exempt charitable entity if it has transgressed the private benefit doctrine. (The IRS occasionally applies this doctrine in cases involving other categories of exempt organizations, such as social welfare organizations and business leagues.) The tax regulations state that an organization is not organized or operated exclusively for one or more charitable purposes "unless it serves a public rather than a private interest." The concept of *private benefit* is a derivative of the operational test. As a court stated, the private benefit proscription "inheres in the requirement that [a charitable] organization operate exclusively for exempt purposes."

The private benefit doctrine differs from the private inurement doctrine in two significant respects. One is that the law formally recognizes the concept of incidental private benefit – that is, types of private benefit that will not cause loss or denial of recognition of tax-exempt status. The other respect is that the private benefit doctrine is applied in the absence of undue benefit to insiders. Thus, a court noted that the private benefit doctrine embraces benefits provided to "disinterested persons." It is from this perspective that it can be said that any transaction or arrangement that constitutes private inurement also constitutes private benefit.

Although tax-exempt charitable organizations may permissibly provide benefits to persons in their private capacity, benefits of this nature must – to avoid jeopardizing exempt status – be incidental both quantitatively and qualitatively in relation to the furthering of exempt purposes. To be *quantitatively incidental*, the private benefit must be incidental, measured in the context of the overall exempt benefit conferred by the activity. To be *qualitatively incidental*, private benefit must be a necessary concomitant of the exempt activity, in that the exempt objectives cannot be achieved without necessarily benefitting certain individuals privately. In some instances, moreover, a private benefit that is more than incidental is nonetheless allowable because provision of the benefit is an exempt function, such as an exempt school providing education and the prospects of employment to its students and the provision of health care by an exempt hospital to its patients.

Intermediate Sanctions

The intermediate sanctions rules emphasize taxation of persons who engaged in impermissible private transactions with certain types of tax-exempt organizations, rather than revocation of the exempt status of these entities. With this approach, tax law sanctions – structured as penalty excise taxes – may be imposed on those persons who improperly benefited from the transaction and on certain managers of the organization who participated in the transaction knowing that it was improper. The penalties in this context are termed *intermediate* sanctions because, when the IRS determines that a form of private inurement has occurred, these penalties stand between the two extremes of the absence of any action by the agency (other than perhaps an examination and a warning) and revocation of the exempt status of the organization. In many ways, the intermediate sanctions rules are a codification of the private inurement proscription.

This body of law applies with respect to tax-exempt public charities, exempt social welfare organizations, and exempt health insurance issuers. These entities are collectively termed, for this purpose, *applicable tax-exempt organizations*. Organizations of this nature include any organization described in one of these three categories of exempt organizations at any time during the five-year period ending on the date of the transaction.

For these purposes, the term *disqualified person* means (1) any person who was, at any time during the five-year period ending on the date of the transaction involved, in a position to exercise substantial influence over the affairs of the organization (whether by virtue of being an organization manager or otherwise); (2) a member of the family of an individual described in the preceding category; (3) and an entity in which individuals described in the preceding two categories own more than a 35-percent interest. An *organization manager* is a trustee, director, or officer of an applicable tax-exempt organization, as well as an individual having powers or responsibilities similar to those of trustees, directors, or officers of the organization. Additional definitions of *disqualified person* apply in the case of supporting organizations with respect to applicable tax-exempt organizations, donors and donor-advisors with respect to donor-advised funds, and investment advisors with respect to sponsoring organizations.

An *excess benefit transaction* is any transaction in which an economic benefit is provided by an applicable tax-exempt organization directly or indirectly to or for the use of a disqualified person, if the value of the economic benefit provided by the organization exceeds the value of the consideration received for providing the benefit. This type of benefit is an *excess benefit*. Excess benefit transactions include those involving payment of compensation, rental arrangements, borrowing arrangements, and sales of assets.

To the extent to be provided in tax regulations, the term *excess benefit transaction* includes any transaction in which the amount of any economic benefit provided to or for the use of a disqualified person is determined in whole or in part by the revenues generated by one or more activities of the organization but only if the transaction results in private inurement. In this context, the excess benefit is the amount of the private inurement. This type of arrangement is known as a *revenue-sharing arrangement*.

An economic benefit may not be treated as consideration for the performance of services unless the organization providing the benefit clearly indicates its intent to treat the benefit as compensation when the benefit is paid. If an organization fails to provide this documentation, any services provided by the disqualified person will not be treated as provided in consideration for the economic benefit for purposes of determining the reasonableness of the transaction. These transactions are thus known as *automatic excess benefit transactions*.

This body of law includes a *rebuttable presumption of reasonableness*, with respect to compensation arrangements and other transactions between an applicable tax-exempt organization and a disqualified person. This presumption arises where the transaction was (1) approved by a board of directors or trustees (or a committee of the board) of an applicable exempt organization that was composed entirely of individuals who were unrelated to and not subject to the control of the disqualified person or persons involved in the transaction, (2) the board (or committee) obtained and relied on appropriate data as to comparability, and (3) the organization adequately documented the basis for its determination.

The intermediate sanctions rules do not apply to any fixed payment made to a person pursuant to an initial contract. A *fixed payment* is an amount of money or other property specified in the contract, or determined by a fixed formula specified in the contract, which is to be paid or transferred in exchange for the provision of specified services or property. An *initial contract* is a binding written contract between an applicable tax-exempt organization and a person who was not a disqualified person immediately prior to entering into the contact.

A disqualified person who benefited from an excess benefit transaction is subject to and must an excise tax – termed the *initial tax* – equal to 25 percent of the amount of the excess benefit. An organization manager who participated in an excess benefit transaction, knowing that it was such a transaction, is subject to and must pay an excise tax of 10 percent of the excess benefit (subject to a maximum amount of tax as to a transaction of $20,000), where an initial tax is imposed on a disqualified person and if there was no correction of the excess benefit transaction within the taxable period. This tax is not imposed, however, where participation in the transaction was not willful and was due to reasonable cause.

Another tax – the *additional tax* – may be imposed on a disqualified person where the initial tax was imposed and if correction of the excess benefit was not accomplished within the taxable period. In this situation, the disqualified person is subject to and must pay a tax equal to 200 percent of the excess benefit involved.

If more than one organization manager or other disqualified person is liable for one of these excise taxes, then all such persons are jointly and severally liable for the tax.

The IRS has the authority to abate an intermediate sanctions excise tax penalty if it is established that the violation was due to reasonable cause and not due to willful neglect, and the transaction was corrected within the appropriate taxable period.

In addition to payment of one or more penalty taxes, the excess benefit transaction must be corrected. The term *correction* means undoing the excess benefit transaction to the extent possible and taking any additional measures necessary to place the applicable tax-exempt organization involved in a financial position that is not worse than the position it would be in if the disqualified person were dealing under the highest fiduciary standards. Generally, a disqualified person corrects an excess benefit transaction only by making a payment in cash or cash equivalents, excluding payment by a promissory note, to the applicable tax-exempt organization involved equal to the correction amount.

This body of law includes definitions of these terms: taxable period, participation, knowing, reasoned written opinion, appropriate professional, willful, and occurrence.

The intermediate sanctions penalties may be imposed by the IRS in lieu of or in addition to revocation of the tax-exempt status of an applicable tax-exempt organization. In general, according to the legislative history of these rules, these sanctions are to be the sole penalty imposed in cases in which the excess benefit does not rise to such a level as to call into question whether, on the whole, the organization functions as an exempt charitable or social welfare organization or health insurance issuer. Guidance was issued as to the facts and circumstances the IRS is to take into account in determining whether to continue to recognize the tax exemption of a charitable organization that engages in an excess benefit transaction that is a violation of the private inurement doctrine.

Commerciality Doctrine

The commerciality doctrine posits that a tax-exempt organization (usually a public charity) is engaged in a nonexempt activity when that activity is undertaken in a manner that is considered to be commercial in nature. An activity is a *commercial* one if it has a direct counterpart in, or is conducted in the same or similar manner as in, the realm of for-profit organizations. The usual sanction for violation of this doctrine is denial of recognition of, or revocation of, tax-exempt status.

The elements of commerciality have been developed by courts. The most prominent explication of these elements has it that commerciality is present where the organization sells goods and/or services to the public, it is in direct competition with for-profit companies, the organization's prices are based on pricing formulae common in for-profit retail, the organization markets its services or products, the organization otherwise advertises, the organization's hours of operation are the same as for-profit companies, the organization has employees (rather than relying on volunteers), and the organization does not receive any charitable contributions.

Commensurate Test

Another test, somewhat related to the operational text, that is sparingly applied by the IRS is the commensurate test. This test is used to assess whether a charitable organization is maintaining program activities that are commensurate in scope with its financial resources. The IRS framed this doctrine in an unpublished technical advice memorandum, where it is written that the test requires that organizations have a charitable program that is “both real and, taking the organization’s circumstances and financial resources into account, substantial.” The agency added: “While there is no specified payout percentage, and while special facts and circumstances may control the conclusion, distribution levels that are low invite close scrutiny.”

The IRS has applied this test in the fundraising context, taking the position that “high” fundraising and administration costs, coupled with a small amount devoted to program, is a violation of the test. The test is also applied in connection with organizations that claim exempt charitable status because they raise funds and make grants for charitable purposes. In the technical advice memorandum, the IRS wrote that an organization that “raises funds for charitable purposes but consistently uses virtually all of its income for administrative and promotional expenses with little or no direct charitable accomplishments cannot reasonably argue that its charitable program is commensurate with its financial resources and capabilities.”

Legislative Activities Limitations

The federal tax law places limitations or restraints on some categories of tax-exempt organizations, particularly charitable organizations and health insurance issuers, as to the extent to which they can engage in attempts to influence legislation.

Generally, for this purpose, *legislation* includes "action with respect to Acts, bills, resolutions, or similar items by the Congress, any State legislature, any local council, or similar governing body, or by the public in a referendum, initiative, constitutional amendment, or similar procedure."

Although legislative activities take many forms of communication, the federal tax law fundamentally distinguishes between direct and indirect lobbying. *Direct* lobbying includes presentation of testimony at public hearings held by legislative committees, correspondence and conferences with legislatures and their staffs, electronic communications, and publication of advocacy documents. *Indirect* – or *grassroots* – lobbying consists of appeals to the public or segments of it to contact legislators or take other specific action regarding legislative matters. As a general rule, attempts to influence the issuance of guidance by executive branch departments and independent agencies is not attempts to influence legislation.

One of the criteria for qualification as a tax-exempt charitable organization is that "no substantial part of the activities" of the organization may constitute "carrying on propaganda, or otherwise attempting, to influence legislation." This is the *substantial part test*, pursuant to which a charitable organization will not be precluded from tax exemption because of lobbying as long as it avoids classification as an action organization.

An organization is regarded as attempting to influence legislation if it (1) advocates the adoption or rejection of legislation, or (2) contacts, or urges the public to contact, members of a legislative body for the purpose of proposing, supporting, or opposing legislation. If a substantial part of a charitable organization's activities is attempting to influence legislation, the organization is denominated an *action organization* and hence cannot qualify as an exempt charitable entity. The term *substantial* is not defined in this context. A third type of action organization is one whose "main or primary objective or objectives . . . may be attained only by legislation or a defeat of proposed legislation," and it "advocates, or campaigns for, the attainment of such main or primary objective or objectives." The rules of the substantial part test do not differentiate between direct and indirect lobbying.

There are some exceptions to the substantial part test (although they are not really exceptions). A charitable organization may solely engage in nonpartisan analysis, study, and research, and publish its results (that is, engage in activities that are educational) without being an action organization. Likewise, a charitable organization that merely responds to a request from a legislative committee to testify is not an action organization.

Because of the vagaries of the substantial part test, an alternative test (in actuality, a safe harbor test) was created: the *expenditure test*. This test, which must be elected, is more complex than the substantial part test, more specifically defines forms of lobbying, provides a mechanism for measuring allowable and non-allowable lobbying, and utilizes an excise tax regime.

The phrase *influencing legislation* means an attempt to influence legislation through communication with any member or employee of a legislative body or with any other governmental official or employee who may participate in formulation of the legislation – a *direct lobbying communication*. This phrase also means an attempt to influence legislation through an attempt to affect the opinions of the public or a segment of the public – a *grassroots lobbying communication*.

A communication with a legislator or government official is a direct lobbying communication only where the communication refers to *specific legislation* and reflects a view on the legislation. Where a communication refers to and reflects a view on a measure that is the subject of a referendum, ballot initiative, or similar procedure, and is made to members of the public in the jurisdiction where the voting will occur, generally the communication is a direct lobbying communication.

A communication is a grassroots lobbying communication only where the communication refers to specific legislation, reflects a view on the legislation, and encourages the recipient of the communication to take action with respect to the legislation. The phrase *encouraging the recipient to take action* with respect to legislation – also known as a *call to action* – means that the communication (1) states that the recipient should contact a legislator or an employee of a legislative body, or should contact any other government official or employee who may participate in formulation of legislation; (2) states the address, telephone number, or similar information of a legislator or an employee of a legislative body; (3) provides a petition, tear-off postcard, or similar material for the recipient to use to communicate with a legislator or an employee of a legislative body, or with any other government official or employee who may participate in formulation of legislation; or (4) specifically identifies one or more legislators who will vote on the legislation as opposing the communication's view with respect to the legislation, being undecided with respect to the legislation, being the recipient's representative in the legislature, or being a member of the legislative committee or subcommittee that will consider the legislation.

The term *specific legislation* is legislation that has been introduced in a legislative body and a specific legislative proposal that the organization supports or opposes. In the case of a referendum, ballot initiative, constitutional amendment, or other measure that is placed on a ballot by petition, an item becomes specific legislation when the petition is first circulated among the voters for signature.

The expenditure test utilizes a mechanical standard for measuring permissible and impermissible ranges of lobbying expenditures by eligible charitable organizations, and does so in terms of the expenditure of funds and sliding scales of percentages. These standards are formulated in terms of declining percentages of total *exempt purpose expenditures,* which generally are amounts paid or incurred to accomplish exempt purposes.

The basic permitted annual level of expenditures for legislative efforts – the *lobbying nontaxable amount* -- is determined by using a sliding scale percentage of the organization's exempt purpose expenditures, as follows: 20 percent of the first $500,00 of an organization's expenditures for an exempt purpose, plus 15 percent of the next $500,000, 10 percent of the next $500,000, and 5 percent of any remaining expenditures. These calculations generally are made on the basis of a four-year average. The total amount spent for legislative activities in any year by an eligible charitable organization may not exceed $1 million. A separate limitation, amounting to 25 percent of the foregoing amounts, is imposed on attempts to influence the public on legislative matters – the *grassroots nontaxable amount*.

A charitable organization that has elected the expenditure test and that exceeds either or both of these limitations becomes subject to an excise tax in the amount of 25 percent of the excess lobbying expenditures; this tax is imposed on the greater of the two excesses. If an electing organization's lobbying expenditures normally (that is, on an average over a four-year period) exceed 150 percent of either limitation -- the *lobbying ceiling amount* and the *grassroots ceiling amount* -- it will lose its tax-exempt status as a charitable entity. A charitable organization in this circumstance cannot convert to an exempt social welfare organization.

Five categories of activities are excluded by statute from the term *influencing legislation* for purposes of the expenditure test: (1) making available the results of nonpartisan analysis, study, or research; (2) providing technical advice or assistance to a governmental body or legislative committee in response to a written request by that body or committee; (3) appearances before or communications to a legislative body with respect to a possible decision of that body that might affect the existence of the organization, its powers and duties, its tax-exempt status, or the deduction of contributions to it (the so-called *self-defense exception*); (4) communications between the organization and its bona fide members with respect to legislation or proposed legislation of direct interest to it and them, unless the communications directly encourage the members to influence legislation or directly encourage them to urge nonmembers to influence legislation; and (5) routine communications with government officials or employees. A sixth exception, created by tax regulation, excuses examinations and discussions of broad social, economic, and similar problems from the ambit of direct lobbying communications and grassroots lobbying communications, even if the problems are of the type with which government would be expected to deal ultimately.

The expenditure test entails methods of aggregating the expenditures of related organizations, to forestall the creation of numerous organizations for the purpose of avoiding the limitations of the expenditure test. Where two or more charitable organizations are members of an affiliated group and at least one of the members has elected coverage under the expenditure test, the calculations of lobbying and exempt purpose expenditures must be made by taking into account the expenditures of the group. If these expenditures exceed the permitted limits, each of the electing member organizations must pay a proportionate share of the penalty excise tax, with the nonelecting member(s) treated pursuant to the substantial part test.

Nearly all other categories of tax-exempt organizations do not have any restrictions as to legislative activity, other than the general requirement that substantially all of the organization’s operations are exempt functions. The one exception is for exempt health insurance issuers, which are subject to the substantial part test. A flow-through rule applicable with respect to membership associations disallows a business expense deduction for the portion of membership dues paid to a tax-exempt organization that engages in lobbying activities; this body of law is primarily directed to business leagues.

Political Campaign Activities Limitation

With one exception – the political organization -- the federal tax laws concerning tax-exempt organizations do not affirmatively encourage their involvement in political campaign activities. The limitations with respect to exempt charitable organizations and exempt health insurance issuers are particularly stringent. The tax law in this regard concerning other types of exempt organizations is vague. Moreover, the law of exempt organizations in this regard interrelates with the federal and state law regulating the financing and conduct of political campaigns.

One of the criteria for qualification as a tax-exempt charitable organization is that it must "not 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." This prohibition on political campaign activity is applicable to campaigns at the federal, state, and local levels; it is also applicable with respect to political campaign activities in foreign countries. If a charitable organization engages in a political campaign activity, it becomes classified as an *action organization* and thus may be disqualified for exempt status. This body of law also applies with respect to exempt health insurance issuers.

The IRS and some courts are of the view that this political campaign activities limitation on charitable organizations is an absolute prohibition. Yet the IRS has the discretion to deny recognition of or revoke tax exemption for violation of this limitation or, in instances of insubstantial campaign activity, only impose a tax on political expenditures. Thus, political campaign activities that only give rise to a tax may be considered incidental ones.

The concept of *participation* or *intervention* in this context is broadly encompassing. These activities include contributions to political campaigns and independent political committees, distribution of statements and other forms of communications, provision of facilities, use of other assets, lending of employees, voter registration efforts, and hosting of debates. The IRS issued guidance on this subject, indicating whether, in 21 factual circumstances, a tax-exempt organization violated this tax law prohibition. There is not much law as to the definitions of terms such as *candidate*, *campaign*, and *public office*.

The federal tax law in this regard as to other categories of tax-exempt organizations is scant. The promotion of social welfare does not include direct or indirect participation or intervention in political campaigns. Thus, an exempt social welfare organization can engage in political campaign activity without jeopardizing its exemption, as long as the activity is not primary. Recent years, nonetheless, have seen an immense rise in the use of social welfare organizations as nonprofit political campaign financing vehicles, particularly in the wake of the U.S. Supreme Court's decision that any ban on independent campaign spending by corporations is unconstitutional.

Expenditures by certain types of tax-exempt organizations for issue advocacy may be taxable as political expenditures pursuant to the political organization's rules. An expenditure by an exempt organization for an advocacy communication relating to a public policy issue may be for an *exempt function* (as that term is used in the political organizations context). When an advocacy communication explicitly advocates the election or defeat of an individual in connection with a public office, the expenditure for the communication obviously is for an exempt function. Otherwise, all of the facts and circumstances must be considered in determining whether the expenditure is for an exempt function.

Governance

The law concerning the governance of public charities and other tax-exempt organizations, including the composition and roles of governing boards, has traditionally been the province of state law, principally nonprofit corporation and trust statutes, augmented by court opinions. In recent years, however, much attention has been given to these matters at the federal law level, largely due to the aggressiveness of the IRS. Today, one of the top priorities of the IRS, in the exempt organizations context, is review of nonprofit entities' governance, with focus on board composition and various policies and procedures. Indeed, this is one of the chief manifestations of the revision of the basic annual information return.

The IRS professes to be inspired by various "good governance" principles and standards that have developed over the years in the realm of nonprofit governance. There are several of these "best practices" standards; despite the IRS's claim to the contrary, they are inconsistent and sometimes conflicting. These standards are developed by nonprofit organizations; the best of them is the "Principles for Good Governance and Ethical Practice," formulated by Independent Sector. The American National Red Cross Governance Modernization Act of 2007 includes a useful outline of the responsibilities of nonprofit boards.

Unrelated Business Rules Overview

The essence of the unrelated business rules is that tax-exempt organizations are permitted to engage in some activities that are not related to their exempt purposes. These rules define what constitutes *unrelated trade or business* and provides that the net income from these activities is subject to federal income tax.

Rationale for the Unrelated Business Rules

The primary objective of the unrelated business rules is to eliminate a source of unfair competition with for-profit businesses, by placing the unrelated business activities of tax-exempt organizations on the same tax basis as the nonexempt business endeavors with which they compete. The notion is that this competition is *unfair* because otherwise exempt organizations would operate without paying taxes, thereby economically undercutting for-profit organizations engaging in the same activity because they have to charge higher prices taking tax obligations into account. A hackneyed expression of this concept is that the unrelated business rules exist to "level the playing field."

Organizations Covered by Rules

The unrelated business rules are applicable to nearly all categories of tax-exempt organizations. These rules are inapplicable to governmental entities, other than colleges and universities that are agencies or instrumentalities of a government or political subdivisions of a government, or that are owned or operated by a government or such political subdivision or by any agency or instrumentality of one or more governments or political subdivisions of them; the rules also apply to any corporation wholly owned by one or more of these colleges or universities. These rules do not apply to instrumentalities of the federal government, certain religious and apostolic organizations, farmers' cooperatives, and shipowners' protection and indemnity associations. The rules are, however, applicable to charitable trusts.

Allowable Unrelated Business

The IRS stated that there is no "quantitative limitation" on the amount of unrelated business in which a tax-exempt organization may engage. Generally, however, unrelated business activities must be confined to something less than a substantial portion of an exempt organization's overall activities. This is a manifestation of the primary purpose test (see above). Although there generally are no specific percentage limitations applied in this area, it is common to measure substantiality and insubstantiality in terms of percentages of expenditures or time.

Definition of Trade or Business

For gross income of a tax-exempt organization to be includable in the computation of unrelated business income it must be income derived from a trade or business. The statutory definition of the phrase *trade or business*, used for purposes of the unrelated business law, is that it includes “any activity which is carried on for the production of income from the sale of goods or the performance of services.” This definition is sweeping, encompassing nearly every activity that an exempt organization may undertake. The definition of this phrase, however, also embraces an activity that otherwise possesses the characteristics of a business as that term is defined by the federal income tax law in the business expense deduction setting.

This incorporation of the business expense deduction concept has led to adoption of a profit motive component as part of the idea of *business* in the unrelated business rules. The U.S. Supreme Court held that the principal test in this regard is that the “taxpayer’s primary purpose for engaging in the activity must be for income or profit.” In the tax-exempt organizations’ context, the Court stated that the inquiry should be whether “the activity was entered into with the dominant hope and intent of realizing a profit.”

As discussed, activities that solely give rise to passive income, usually investment income, are generally not considered businesses undertakings. A set of activities may, nonetheless, entail more than just passive investing. Courts have dubbed this concept *investment plus*. Where there is investment plus, there usually is an active business.

Fragmentation Rule

The *fragmentation rule* states that an "activity does not lose identity as trade or business merely because it is carried on within a larger aggregate of similar activities or within a larger complex of other endeavors which may, or may not, be related to the exempt purpose of the organization." Thus, this rule grants the IRS and courts the authority to treat net income from an activity as unrelated business income where the activity is an integral part of a cluster of activities that is in furtherance of an exempt purpose. To ferret out unrelated business, the IRS regards an exempt organization as a bundle of activities, evaluating each of them in isolation to determine if one or more of them constitute a trade or business. This assessment process is known as *fragmentation*.

Definition of Regularly Carried On

The gross income of a tax-exempt organization may be includable in the computation of unrelated business income where the trade or business that produced the income is regularly carried on by the organization. In determining whether a trade or business conducted by an exempt organization is *regularly carried on*, regard must be had to the frequency and continuity with which the activities productive of income are conducted and the manner in which they are pursued.

Business activities of an exempt organization will ordinarily be deemed to be regularly carried on if they manifest a frequency and continuity and are pursued in a manner generally similar to comparable commercial activities of nonexempt organizations.

Where income-producing activities are of a kind normally conducted by commercial organizations on a year-round basis, the conduct of the activities by a tax-exempt organization over a period of only a few weeks does not constitute the regular carrying on of a business. If income-producing activities are of a kind normally undertaken by commercial organizations only on a seasonal basis, the conduct of the activities by an exempt organization during a significant portion of the season ordinarily constitutes the regular conduct of a business. The IRS occasionally asserts that the time expended by an exempt organization in preparing for the conduct of a business should be taken into account in assessing whether an activity is regularly carried on.

Definition of Substantially Related

To reiterate, gross income of a tax-exempt organization may be includable in the computation of unrelated business income where three elements are present, two of which are that the income is from a trade or business and the trade or business is regularly carried on. The third of these elements is that the trade or business is not substantially related to the exempt purposes of the exempt organization. Where these three elements are present, the activity involved is an *unrelated business*. If the third element is absent, the activity is likely a *related business*. The fact that an organization needs or uses the funds for an exempt purpose does not make the underlying activity a related business.

A trade or business is *related* to tax-exempt purposes of an exempt organization only where the conduct of the business has a causal relationship to the achievement of an exempt purpose; it is *substantially related* only if the causal relationship is a substantial one. For the conduct of a business from which an amount of gross income is derived to be substantially related to exempt purposes, the production or distribution of goods or the performance of services from which the gross income is derived must contribute importantly to the accomplishment of these purposes. Whether activities productive of gross income contribute importantly to accomplishment of an organization’s exempt purposes depends in each case on the facts and circumstances involved.

Advertising

Income from the sale of advertising in periodicals of tax-exempt organizations and other types of communications generally constitutes unrelated business income, taxable to the extent it exceeds the expenses directly related to the advertising. If, however, the editorial aspect of the periodical is carried on at a loss, the editorial loss may be offset against the advertising income from the periodical. Income attributable to a periodical of an exempt organization basically is regarded as *circulation income* or (if any) *gross advertising income*. The costs attributable to an exempt organization periodical are characterized as *readership costs* and *direct advertising costs*.

Membership dues must be allocated to circulation income where the right to receive a periodical is associated with membership status in the tax-exempt organization for which dues, fees, or other charges are received. There are three ways to make this allocation.

Special Rules

Special unrelated business rules are applicable to social clubs, voluntary employees' beneficiary associations, and supplemental unemployment benefit trusts. These rules apply the unrelated business income tax to all of these organizations' net income other than exempt function income. *Exempt function income* is of two types: (1) gross income from amounts (such as dues) paid by members of the organization as consideration for the provision of goods, facilities, or services in furtherance of exempt purposes, and (2) income that is set aside for a charitable purpose or (other than in the case of social clubs) to provide for payment of life, sick, accident, or other benefits, subject to certain limitations.

In the case of veterans' organizations, the term *unrelated business taxable income* does not include any amount attributable to payments for life, sick, accident, or health insurance with respect to members of the organizations or their dependents that is set aside for the purpose of providing for the payment of insurance benefits or for a charitable purpose.

Small Business Corporations Rules

A tax-exempt charitable organization may be a shareholder in an S corporation, which is a corporation that is treated for federal income tax purposes as a partnership. Items of income, loss, or deduction of an S corporation flow through to eligible exempt organization shareholders as unrelated business income. Gain or loss on the disposition of stock in an S corporation also results in unrelated business income.

Exceptions for Forms of Income

The unrelated business rules were enacted to ameliorate the effects of competition between tax-exempt organizations and for-profit businesses by taxing the net income derived by exempt organizations from the conduct of unrelated business activities. The principle underlying this statutory scheme is that the business endeavors of exempt entities must be *active* ones for competitive activity to result. The corollary to this principle is that income obtained by an exempt organization in a *passive* manner generally is income that is not acquired as the result of competitive undertakings. Consequently, most forms of passive income received by exempt organizations are not taxed as unrelated business income. These exemptions from taxation are euphemistically termed *modifications*.

Exceptions from unrelated business income taxation include those provided for dividends, interest, income with respect to the lending of securities, annuities, royalties, rent, capital gains, and income derived from research.

Exemption for Royalties

The exemption from unrelated business income tax for royalties is not unlimited. The basic definition of a *royalty* is that it is a payment for the use of a valuable intangible right, such as a trademark, trade name, service mark, logo, or copyright; royalties also include the right to a share of production reserved to the owner of the property for permitting another person to work mines and quarries or to drill for oil or gas.

The principal issue in the tax-exempt organizations area, that may circumscribe the reach of the term *royalty*, is the provision of services by an exempt organization to induce income flow in the form of the ostensible royalty. In the main court decision on the point, a federal appellate court wrote that a payment cannot constitute a royalty for these purposes to the extent it represents "compensation for services [other than insubstantial ones] rendered by the owner of the property." This opinion concerned the extent to which an exempt organization may characterize payments to it, in connection with its members' use of affinity cards, as a royalty where the organization was engaging in activities promoting use of the cards. If the exempt organization's services in this context are more than incidental, the IRS and/or a court may view the relationship between the parties as a joint venture, defeating the possibility of treating the income flow to the organization as an exempted royalty.

Exemption for Rent

The exemption from unrelated business income tax for rent is similarly not boundless. In general, the rental of real estate constitutes the carrying on of a trade or business. *Rent* is a form of income that is paid for the occupation or similar use of property, usually real property.

Payments for the use or occupancy of entire private residences or living quarters in duplex or multiple housing units, or of offices in an office building and the like are generally treated as rent from real property, which is exempt from unrelated business income taxation. Where, however, a tax-exempt organization undertakes functions beyond normal maintenance services, such as services rendered primarily for the convenience of the occupants (for example, cleaning services), the payments will not be considered as from a passive source (and hence not exempt from tax) but instead from an unrelated business (assuming that the activity is regularly carried on and is not substantially related to the organization's exempt purposes).

Moreover, the exemption for rent does not apply if determination of the amount of the rent depends in whole or in part on the income or profits derived by a person from the property leased (other than an amount based on a fixed percentage or percentages of receipts or sales). This rule is intended to prevent avoidance of the unrelated business income tax where a profit-sharing arrangement would make the lessor an active participation in operation of the property.

Further, the exemption from unrelated business taxable income for rent of personal property leased with real property is limited to instances where the rent attributable to the personalty is incidental, that is, no more than 10 percent of the total rent. Also, this exemption is not available where the rent attributable to personalty is tied to the user's income or profits or if more than 50 percent of the total rent is attributable to the personal property leased.

On occasion, rental income is derived by a tax-exempt organization from operation of a related business, so the revenue is nontaxable for that reason.

Exemption for Capital Gain

As with royalties and rent, the exemption for gains from the disposition of capital gain property has boundaries. This exemption does not extend to dispositions of inventory or property held primarily for sale to customers in the ordinary course of a business. The IRS applies eight factors in determining whether property is being sold in the ordinary course of business.

The standard followed in making these determinations, as to whether property is being held primarily for sale in the ordinary course of business or is held for investment, is a primary purpose test. Tax-exempt organizations are often in this position, where they have held real estate for years, then decide to develop the property and sell it in increments. The issue then is whether the organization is engaging in investment activity (resulting in exempted capital gain) or is a dealer in real property (with the resulting income being ordinary income and thus not exempt from tax). The ideal circumstances, for preservation of this capital gains exemption, are acquisition by an exempt organization of the real property by gift or devise, a long holding period, little or no development of the property by the organization, little or no marketing by the organization of availability of the property, and a valid reason for its sale.

Occasionally, land development and sales are activities in furtherance of an exempt purpose.

Exemption for Research Income

Income derived from research is excluded from unrelated business income taxation where the research is for government; for anyone, in the case of tax-exempt colleges, universities, and hospitals; and by "fundamental research" units. In employing the term *research* in this context, the IRS generally looks to the body of law defining the term in relation to what is considered exempt scientific research.

Exemptions for Various Activities

Statutory exemptions from the unrelated business income tax are provided for many types of activities, including volunteer-conducted businesses, convenience businesses, sales of gift items, certain entertainment activities, trade shows, distributions of low-cost articles, and certain exchanges or rentals of membership or donor lists. Another exception applies in the case of corporate sponsorships (see below).

Volunteer-Conducted Businesses

Exempt from the scope of taxable unrelated trade or business is a business in which substantially all of the work in carrying on the business is performed for a tax-exempt organization without compensation.

Substantiality is generally assessed in terms of hours expended; *substantially all* means at least 85 percent. Economic benefits can be considered *compensation*, even if not formally cast as a salary or fee for service, unless they are incidental.

Convenience Businesses

Excluded from unrelated business income taxation, in the case of a tax-exempt charitable organization or a state college or university, is a business that is carried on by the entity primarily for the convenience of its members, students, patients, officers, or employees.

Sales of Gift Items

Unrelated trade or business does not include a business, conducted by a tax-exempt organization, that constitutes the selling of merchandise, substantially all of which has been received by the organization as contributions. This exemption originated for nonprofit thrift shops that sell donated clothing, books, furniture, and similar items to the public. It can be utilized, however, in conjunction with other activities, such as a property donation program, where contributed vehicles and other property are sold to generate funds for the organization's programs. Again, *substantially all* means at least 85 percent.

Entertainment Activities

Another exemption from unrelated business income taxation is applicable with respect to the conduct of entertainment at fairs and expositions. This rule applies with respect to charitable, social welfare, labor, agricultural, and horticultural organizations that regularly conduct, as a substantial exempt purpose, an agricultural and/or educational fair or exposition. Thus, the concept of *unrelated trade or business* does not include *qualified public entertainment activities* conducted by an eligible organization.

Trade Shows

Activities that promote demand for industry products and services, such as advertising, generally constitute commercial businesses if regularly carried on for the production of income. The federal tax law provides what the IRS termed a "narrow exception" in this context for certain types of tax-exempt organizations that conduct industry promotion activities in connection with a convention, annual meeting, or trade show. This exemption for trade show activities is available for charitable, social welfare, labor, agricultural, and horticultural organizations, and business leagues, that regularly conduct, as a substantial exempt purpose, shows that stimulate interest in and demand for the products of a particular industry or segment of industry or that educate individuals in attendance regarding new developments, products, or services related to the exempt purposes of the organization. Thus, the concept of *unrelated business* does not include *qualified convention and trade show activities* conducted by an eligible organization.

Low-Cost Articles

Another exemption from unrelated business income taxation is available only for tax-exempt organizations eligible to receive tax-deductible charitable contributions, for activities relating to certain distributions of low-cost articles incidental to the solicitation of charitable contributions. The term *low-cost article* is defined to be any article (or aggregate of articles distributed to a single distributee in a year) that has a cost not in excess of $5 (adjusted for inflation) to the organization that distributes the item or on behalf of which the item is distributed. This body of law requires that distribution of the items be unsolicited and accompanied by a statement that the recipient may retain the article irrespective of whether a charitable contribution is made.

Mailing Lists

Another exemption from unrelated business income taxation, available to the categories of tax-exempt organizations eligible for the exemption for low-cost articles is applicable to the exchanging or rental of membership or donor mailing lists with or to another of these types of exempt organizations.

Provision of Services

In general, net income from the provision of services by a tax-exempt organization to another organization, including another exempt organization, is unrelated business income. It is possible, however, that an exempt organization providing services to another exempt organization is engaging in a related business.

Also, this type of income is exempt from unrelated business income taxation where the tax-exempt organizations are related, usually as parent and subsidiary. The IRS terms these services *corporate services*; the resulting financial arrangements are viewed as *merely a matter of accounting*, which is to say disregarded. Indeed, the IRS extends this matter-of-accounting rationale to arrangements where the relationship is analogous to parent-subsidiary relationships.

Corporate Sponsorships

The receipt of a qualified sponsorship payment by a tax-exempt organization is not the receipt of income that is considered unrelated business income. A *qualified sponsorship payment* is a payment of money, transfer of property, or performance of services, by a person engaged in a commercial trade or business to an exempt organization, with respect to which there is no arrangement or expectation that the person will receive a substantial return benefit. A *substantial return benefit* is any benefit, other than (1) goods, services, or other benefits of insubstantial value that are disregarded or (2) certain uses and acknowledgements. A substantial return benefit includes advertising; the provision of facilities, services, or other privileges to the payor or persons designated by the payor; and granting the payor an exclusive or nonexclusive right to use an intangible asset (such as a trademark, patent, or logo) of the exempt organization. A substantial return benefit does not include the use or acknowledgment of the name, logo, or product lines of the payor's trade or business.

Goods, services, or other benefits are disregarded in two sets of circumstances. One circumstance is where the benefits provided to the payor have an aggregate fair market value that is not more than 2 percent of the amount of the payment or $75 (adjusted for inflation), whichever is less. The other circumstance is where the only benefits provided to the payor are token items, such as T-shirts, bookmarks, calendars, key chains, mugs, and posters, bearing the exempt organization's name or logo that have an aggregate cost within the limit established for low-cost articles.

If there is an arrangement or expectation that the payor will receive a substantial return benefit with respect to a payment, only the portion of the payment (if any) that exceeds the fair market value of the substantial return benefit is a qualified sponsorship payment. The term *qualified sponsorship payment* does not include any payment, the amount of which is contingent, by contract or otherwise, on the level of attendance at one or more events, broadcast ratings, or other factors indicating the degree of public of public exposure to the sponsored activity.

The unrelated business income tax treatment of any payment (or portion of one) that is not a qualified sponsorship payment is determined by application of the general rules in the unrelated business body of law. For example, payments related to the exempt organization's provision of facilities, services, or privileges to the payor; advertising; exclusive provider arrangements; a license to use intangible assets of the exempt organization; or other substantial return benefits are evaluated separately in determining whether the exempt organization is receiving unrelated business income. Thus, the corporate sponsorships rules are a form of a "safe harbor" law.

Unrelated Debt-Financed Income Rules

In computing a tax-exempt organization's unrelated business taxable income, there must be included with respect to each debt-financed property that is unrelated to the organization's exempt function – as an item of gross income derived from an unrelated trade or business -- an amount of income from the property, subject to tax in the proportion in which the property is financed by the debt. The allowable deductions are those that are directly connected with the debt-financed property or its income, although any depreciation may only be computed on the straight-line method. As the debt is paid, the portion of the income that is subject to tax usually diminishes.

The term *debt-financed property* generally means property that is held to produce income and with respect to which there is an acquisition indebtedness at any time during the tax year (or during the preceding 12 months if the property is disposed of during the year). The six exceptions from this term are for (1) property where substantially all (at least 85 percent) of its use is substantially related to the exercise or performance by the organization of its exempt purpose or, if less than substantially all of its use is related, to the extent that its use is substantially related to an exempt purpose; (2) property to the extent that it income is subject to tax as income from conduct of an unrelated business; (3) property to the extent that the income is derived from research activities; (4) property to the extent its use is in a business where substantially all of the work is performed without compensation; (5) property to the extent that its use is in a qualified convenience business, and (6) property to the extent that its use is in a business involving the sale of merchandise, substantially all of which was received as contributions.

Acquisition indebtedness, with respect to debt-financed property, means the (1) unpaid amount of the indebtedness incurred by a tax-exempt organization in acquiring or improving the property, (2) indebtedness incurred before any acquisition or improvement of the property if the indebtedness would not have been incurred but for the acquisition or improvement, and (3) indebtedness incurred after acquisition or improvement of the property if the indebtedness would not have been incurred but for the acquisition or improvement and the incurring of the indebtedness was reasonably foreseeable at the time of the acquisition or improvement.

There are several exceptions to the definition of *acquisition indebtedness.* The principal one is that the term does not include indebtedness that was incurred in circumstances where incurrence of the debt was inherent in performance of a tax-exempt function of an organization or otherwise in advancement of an organization's exempt purpose. Another exception is for obligations of an exempt organization to pay a qualified annuity.

The term *acquisition indebtedness* does not include indebtedness incurred by a qualified organization in acquiring or improving real property. A *qualified organization* is an operating educational institution, a supporting organization with respect to an educational institution, a tax-exempt multiparent title-holding organization, as well as certain pension trusts.

Unrelated Business Income Tax

The unrelated business income tax rate, payable by most tax-exempt organizations on their unrelated business taxable income, is the corporate rate, which is a flat tax of 21 percent of taxable income. Some organizations, such as trusts, are subject to the individual income taxes.

In four instances, tax-exempt organizations must take forms of income into account as unrelated income because the income is deemed to be unrelated business income, in whole or in part, by statute. These are (1) certain amounts of income derived from partnerships and other joint ventures, (2) forms of debt-financed income (with exceptions), (3) certain amounts received by controlling organizations from controlled organizations, and (4) income from insurance activities conducted by offshore captives of tax-exempt organizations.

Tax-exempt organizations must make quarterly estimated payments of the tax on unrelated business taxable income, in accordance with the same rules requiring quarterly estimated payments of corporate income taxes. Revenue and expenses associated with unrelated business activity are required to be reported to the IRS on a tax return (IRS Form 990-T).

Unrelated Business Income Tax Deductions

Generally, the phrase *unrelated business taxable income* means gross income derived by a tax-exempt organization from an unrelated business, regularly carried on by the organization, less business deductions that are directly connected with the carrying on of the business. To be *directly connected with* the conduct of an unrelated business, an item of deduction must have a proximate and primary relationship to the carrying on of that business. In the case of an exempt organization that derives gross income from the regular conduct of two or more unrelated business activities, unrelated business taxable income is computed on a business-by-business basis, so that the deduction associated with a particular business can only be taken against the income from that business. This is known as the *bucketing rule*.

The bucketing rule is a matter of considerable controversy. When this law was enacted, Congress did not provide criteria for determining when a tax-exempt organization has more than one unrelated business or how to identify separate unrelated businesses for purposes of calculating unrelated business taxable income. Under the tax regulations, organizations use the first two digits of the North American Industry Classification System codes to ascertain separate businesses. Many investment activities are a single business, including qualifying partnership interests. Otherwise, partnership interests and deemed unrelated income arrangements are separate businesses.

Expenses, depreciation, and similar items attributable solely to the conduct of unrelated business are proximately and primarily related to that business and therefore qualify for deduction to the extent that they meet the requirements of relevant provisions of the federal income tax law.

Where facilities and/or personnel are used both to carry on tax-exempt activities and to conduct unrelated trade or business, the expenses, depreciation, and the like (such as overhead and salaries) must be allocated between the two uses on a reasonable basis. Where gross income is derived from an unrelated business that exploits an exempt function, expenses, depreciation, and the like attributable to conduct of the exempt function are not deductible in computing unrelated business taxable income.

A tax-exempt organization will be denied business expense deductions in computing its unrelated business taxable income if it cannot adequately substantiate that the expenses were incurred or that they were directly connected with the unrelated activity.

Chapter 2: Formation Basics

General Nonprofit Organization Law

The law as to the definition of the term *nonprofit organization* and the organization of these entities generally are elements of state law. State law, for example, almost always includes a nonprofit corporation act, which, among other law aspects, states the required contents of articles of incorporation and provides rules by which a nonprofit corporation is operated.

State nonprofit law is also likely to discuss rules for trusts; antitrust, securities, and insurance laws as they apply to nonprofit entities; provide for tax exemptions (from income, sales, use, and/or property taxes) and charitable deductions; contain law pertaining to investment principles; and include a charitable solicitations act. Still other nonprofit law areas that are matters of state law are governance, fiduciary responsibility, and officers' and directors' liability.

You, the founder of the organization, need to decide, at the outset or along the way, whether you are going to retain the services of a lawyer who concentrates on nonprofit law. You will not be surprised to learn that I recommend doing so.

Tax Exemption

Tax exemption for nonprofit organizations is essentially a federal tax law subject. As noted, states (and perhaps other forms of government) have exemption law but this subject is dominated and guided by federal law.

The Internal Revenue Code provides that “[e]xcept as otherwise provided in this subtitle [Subtitle A, pertaining to income taxes], gross income means all income from whatever source derived,” including items such as compensation for services, interest, dividends, and receipts derived from the conduct of a trade or business. The Code provides for a variety of deductions, exclusions, and exemptions in computing taxable income. Of pertinence in the tax-exempt organizations law setting is the body of exemption provisions included in the Code.

Exemption from federal income taxation is based on a specific provision to that end in the Code. A federal tax exemption generally is a privilege, a matter of legislative grace, rather than an entitlement. Tax exemption, being an exception to the norm of taxation, is often strictly construed. Nonetheless, provisions according tax exemption for charitable organizations are usually liberally construed.

The Code contains a provision that is the general source of the federal income tax exemption. This provision states that an “organization described in subsection [501](c) or (d) or section 401(a) shall be exempt from taxation under this subtitle [Subtitle A] unless such exemption is denied under section 502 or 503." The U.S. Supreme Court characterized this provision as the "linchpin of the statutory benefit [tax exemption] system."

A nonprofit organization that seeks to be tax-exempt bears the burden of proving that it satisfies all of the requirements of the exemption statute involved.

Concept of Nonprofit Organization

The Supreme Court, on one occasion, offered a definition of the term *nonprofit organization*, writing that a "nonprofit entity is ordinarily understood to differ from a for-profit corporation principally because it is barred from distributing its net earnings, if any, to individuals who exercise control over it, such as members, officers, directors, or trustees." State law is likely to provide some refinements of or additions to this definition.

Types of Nonprofit Organizations

The federal tax law recognizes four types of nonprofit organizations. They are nonprofit corporations, unincorporated associations, trusts, and limited liability companies. Which one of these types should be selected in any particular circumstance is often dictated by state and federal law, and the lawyer's predilections. As to the latter, for example, some lawyers (including me) favor corporations, while others prefer trusts. A key factor in deciding the appropriate type of nonprofit organization is the extent to which it provides legal liability protection for those who govern it (trustees, directors, officers, and key employees).

Nonprofit organizations are formed by the creation (and sometimes the filing) of a document termed the *articles of organization*. For the incorporated organization, the articles of organization are *articles of incorporation* (known in a few states as a certificate of incorporation). A trust is organized by means of a *declaration of trust* or a *trust agreement*. An unincorporated association is formed by use of a *constitution*. A limited liability company is created by execution of an *operating agreement*. Most exempt organizations have an instrument stating the rules pursuant to which the organization is operated, termed *bylaws*.

Regardless of the form of the organization that is selected, it is important to craft a comprehensive and engaging (and legally formulated) statement of purposes. This statement should appear in the articles of organization. Some organizations like to have a longer mission statement. If both statements are desired, please be certain they are consistent.

Next Twenty Steps

As noted, the first step (other than this matter of a lawyer) is to settle on the organization's form. I will assume you have selected the corporate form. The following next steps need to be taken. As you contemplate these decisions, particularly if you are designing the nonprofit organization in the absence of competent legal counsel, try to see how the decision will be reflected in answers to the questions on the application for recognition of exemption (if there is one) (see Chapter 3) and later on the annual information return (see Chapter 5).

1. Decide on the state (or D.C.) in which the organization will be formed.

2. Decide (if you know at the outset) if the organization will be "doing business" in one or more other states.

3. Decide who will be the organization's initial directors (or trustees).

4. Decide (this one and the remaining others may well be a board decision) what the initial officer positions in the organization will be and who will fill them.

5. Decide on the location and nature of the organization's office/headquarters.

6. Decide whether the organization will purchase directors' and officers' liability insurance.

7. Decide if the organization is to have members.

8. Prepare, taking into account the elements of the organizational test (see Chapter 1), and file the articles of organization.

9. Decide whether or not to have bylaws (I heartily recommend them) and, if they are desired, prepare them.

10. Decide on the place and date for the organizational meeting of boards and/or members.

11. Decide what the organization's activities will be, taking into account the elements of the operational test (see Chapter 1).

12. Contemplate the nature of the organization's funding.

13. Decide if the organization will be (or try to be) tax-exempt under federal and state law (see Chapter 3).

14. Decide, if the organization is to be a charitable entity, whether it is to be a public charity (and, if so, which type) or a private foundation (see Chapter 4).

15. Decide if the organization will engage in lobbying (see Chapter 1).

16. Decide if the organization will participate in political campaign activity (same chapter).

17. Determine whether the organization will have

employees.

18. Determine whether the organization will use the services of independent contractors (other than lawyers), such as an accountant, investment advisor, and/or fundraising or management consultant.

19. Decide on compensation arrangements.

20. Decide on what (if any) governance policies will be adopted.

Comments on most of these 20 elements follow.

Jurisdiction

A U.S. nonprofit organization has to be formed in a state (or D.C.). For example, nearly every one of these jurisdictions has a nonprofit corporation act. Usually, a nonprofit organization is formed (and has its headquarters) in the state where the founder or founders reside or work. Occasionally, another state will be selected, often in the belief (often inaccurate) that that environment or legal system is more favorable to nonprofits, such as Delaware, New York, or Washington, D.C. The state of formation and principal operations is the *domestic* jurisdiction.

Doing Business

It may not be a factor at the outset but at some time along the way the organization may decide to do business in another state, such as operate a program or series of conferences there. This does not entail another incorporation (or similar process). Rather, the organization obtains a request to do business in the other state, which is a *foreign* jurisdiction.

Board of Directors

Every nonprofit organization – irrespective of form – must have at least one director (or trustee). Most state nonprofit corporation laws require at least three directors; some states permit just one. Trusts often have only one trustee. There is no "one size fits all" – the optimum size of a governing board depends on several factors, such as the size of the organization, whether there is a large membership that elects directors, the need for certain fields of expertise to be represented on the board, and interests in diversity of viewpoints. Particularly with charitable organizations, the IRS has a policy of finding private benefit in cases of small boards and boards with related individuals (see Chapter 1). Matters worsen when there's both.

Directors of nonprofit organizations, particularly charitable entities, are fiduciaries. A fiduciary relationship arises when a person appropriately places confidence and trust in another person, usually when seeking advice or some form of other assistance in a matter (such as assets management). Board members of nonprofit organizations have the responsibility to act prudently in their handling of the organization's resources. The duties of a nonprofit organization's board can be encapsulated in three categories of duties: the duty of care, duty of loyalty, and duty of obedience. Defined by state statute and/or case law, these are the legal standards by which all actions taken by board members are judged.

Officers

Nonprofit organizations, other than trusts, almost always have officers. It is the role of the officers to implement policies established by the governing board (and perhaps a membership) and run the organization on a day-to-day basis. State law may dictate some officer positions; for example, state nonprofit corporation acts usually provide that there must be a president, secretary, and treasurer. Organization are free to add others, such as one or more vice-presidents, an assistant secretary, and/or an assistant treasurer.

Office Headquarters

Like any type of organization, a nonprofit entity needs a home – a base of operations. Some thought should be given to this decision, in terms of cost and appearances. A nonprofit organization can rent or own office space; a lucky few have space provided for them without charge. This expense factor is a matter of reason and prudence: donors, the media, and regulators generally frown on opulent headquarters. An effort should be made to not rent office space from a board member or set up operations in someone's home.

Membership

One of the structural considerations is whether the nonprofit organization is to have a membership. As a general principle, memberships are to be avoided, because of the additional costs and complexities associated with that feature. Of course, in some instances, a membership is unavoidable: e.g., business leagues, labor unions, social clubs, and veterans' and fraternal groups. Some organizations refer to clumps of individuals as "members," even though they actually aren't (they're donors).

Bylaws

A set of bylaws is generally a good idea for nonprofit organizations, other than trusts. It is just good practice to have a written package of rules that answer the basic questions about the formality of operations. These rules are those that ought not be in articles of organization (if only because of the difficulty of amendment).

Employees

There is no requirement in the law that a nonprofit organization have employees. Most nonprofit entities, of course, have them, by necessity. (Few organizations can rely wholly on volunteers anymore.) The number of employees will be dictated by budget concerns and the realities of program implementation. There may be one employee or hundreds. There may be an executive staff (key employees).

Compensation

If there will be employees, there will be, by definition, compensation. The operative dynamic here is that the compensation must be reasonable (see the discussion of private inurement, private benefit, and excess benefit transactions in Chapter 1). This dynamic also applies with respect to independent contractors and board members. Yes, board members may – as a matter of law – be compensated.

Governance Policies

Thanks to the IRS and its current iteration of the larger annual information return (see Chapter 5), the matter of adoption of and adherence to governance policies looms large. There are over 30 of them to choose from. Not all policies are for all organizations, of course. In fact, with few exceptions, these policies are not required by law. Some, however, are warranted by good management precepts.

The most venerable of the policies in the bundle of "good governance" practices involving nonprofit organizations (and the one most heartily insisted on by the IRS) is the conflict-of-interest policy. For the larger organizations, whistleblower policies and document retention and destruction policies are good ideas. Two other policies come highly recommended: an investment policy and an expense reimbursement policy (the latter in the form of an accountable plan). Many charitable entities should seriously consider a gift acceptance policy and perhaps a fundraising policy.

The second tier of policies are the executive compensation policy, a joint venture policy, a meetings documentation policy, and an annual information return policy. Unique policies include a policy concerning affiliates, a conservation easement policy, and an international grantmaking policies. Hospitals are expected to have charity care, financial assistance, and debt collection policies. Some organizations have a code of ethics.

Insurance

Four basic ways are available for a nonprofit organization to protect itself, and its board members and officers, against legal liability. One way is incorporation. Another way is inclusion of an indemnification clause in the bylaws. Several states have immunity laws for officers and directors of nonprofit entities. The fourth way is D&O insurance, which, of course, transfers the risk of liability to an independent third party (an insurance company). Most lawyers (including me) are of the view that D&O insurance is appropriate for nonprofit organizations.

Concept of Tax-Exempt Organization

The term *tax-exempt organization* is somewhat of a fabrication, in that nonprofit organizations are rarely excused from exposure to all taxes, including the federal income tax. There are, of course, other applicable federal taxes, such as excise and employments taxes; there are categories of exemptions from them. At the state level, exemptions are associated with income, sales, use, excise, and property taxes.

The income tax that is potentially applicable to nearly all tax-exempt organizations is the tax on income derived from an unrelated trade or business. Exempt entities can be taxed for engaging in political activities; public charities are subject to tax in the case of substantial efforts to influence legislation or participation in political campaign activities; business leagues may elect to pay a proxy tax; donor-advised funds are subject to taxes; and some exempt organizations, such as social clubs and political organizations, are taxable on their net investment income. Private foundations are caught up in a variety of excise taxes. Some private colleges and universities pay an excise tax on their net investment. Exempt organizations can be taxed if they pay one or more employees in excess of $1 million annually.

This anomaly of a tax-exempt organization being an entity that is subject to various taxes is addressed in the Internal Revenue Code. There it is written that an organization that is exempt from tax shall nonetheless be subject to certain taxes but, notwithstanding that eligibility for taxation, "shall be considered an organization exempt from income taxes for the purpose of any law which refers to organizations exempt from income taxes."

Recognition of Tax Exemption

As the foregoing indicates, tax exemption exists when it is provided by statute. That is, exemption cannot be granted by implication. Only a legislature (e.g., Congress) can create and maintain a tax exemption.

A tax exemption, however, may be administratively *recognized* (such as by the IRS); indeed, a law may mandate this recognition. Recognition of exemption is accomplished, where the organization qualifies for the exemption, by the agency involved by issuing a written determination that the entity is exempt. This writing is merely an agreement by the agency with the nonprofit entity involved that it is tax-exempt. The exemption involved was, as noted, granted by the appropriate legislature.

At the federal level, generally, recognition of tax exemption by the IRS is not required. Some nonprofit organizations, however, are required, to be exempt, to obtain recognition of the federal tax exemption. These entities are charitable ones (with exceptions), credit counseling organizations that are to be social welfare entities, nonprofit health insurance issuers, certain prepaid tuition plans, and certain employee benefit entities.

The IRS has designed forms to be used to apply for recognition of tax exemption. They are titled Applications for Recognition of Exemption. The principal applications are Form 1023 (used by charitable organizations) and Form 1024 (used by most of the other categories of exempt organizations). A nonprofit organization may file an application for recognition of exemption even if it is not required to do so.

The IRS refers to the types of entities that are not required to seek recognition of tax exemption as *self-declarers*. These self-declarers include social welfare organizations, labor organizations, business leagues, and social clubs.

Charitable Organizations in General

The phrase *charitable organization* is used in two ways. One, it is used to describe all organizations referenced in IRC § 501(c)(3), including educational, scientific, and religious entities. This is because – with one minor exception – all of these organizations are eligible to receive deductible charitable contributions. Two, it is used in a more technical sense, referencing 30 ways to be charitable.

The types of activities that qualify as *charitable* ones, for federal tax purposes, are referenced in the tax regulations, IRS revenue rulings or procedures, or court opinions. They are:

- Relief of the poor.
- Relief of the distressed.
- Relief of the underprivileged.
- Advancement of religion.
- Advancement of education.
- Advancement of science.
- Erection, maintenance of buildings and/or monuments.
- Lessening the burdens of government.
- Promotion of social welfare by lessening neighborhood functions.

- Promotion of social welfare by eliminating prejudice and discrimination.
- Promotion of social welfare by defending human and civil rights secured by law.
- Promotion of social welfare by combating community deterioration and juvenile delinquency.
- Testing for public safety.
- Credit counseling.
- Provision of housing for low-income individuals.
- Down payment assistance.
- Promotion of health.
- Promotion of the arts.
- Operation of consortia.
- Fundraising for charity.

- Environmental protection.
- Promotion of patriotism.
- Promotion of sports for youth.
- Practice of public interest law.
- Certain forms of economic development.
- Care of orphans.
- Facilitation of student and cultural exchanges.
- Maintenance of public confidence in the legal system.
- Sponsorship of donor-advised funds (see Chapter 4).
- Functioning as an instrumentality of a government.

Some of these ways to be charitable overlap. For example, the operation of consortia, promotion of sports for youth, and facilitation of student and cultural exchanges are activities usually considered forms of advancement of education. Likewise, eligible economic development activities are often forms of promotion of social welfare and/or lessening the burdens of government.

Tax-exempt charitable organizations are either public charities or private foundations (see Chapter 4).

Educational Organizations

The federal tax law does not contain a threshold, generic definition of the term *educational*; it rests on the concept that subjects spoken or written about must be objectively founded or developed. This is manifested in the *full and fair exposition test*, which permits materials that advocate a viewpoint to qualify as educational in nature but only if the advocacy is preceded by an objective discussion of the issue or subject involved. Thereafter, the IRS advanced a *methodology test*, pursuant to which a communication is evaluated by that agency to determine whether it is *educational*, as opposed to *propaganda*. In applying this test, the IRS is supposed to avoid any examination of the content of a communication (because of constitutional law considerations) and focus only on the method by which an advocate proceeds from the premises furnished to the conclusion advocated. If a communication is propaganda – that is, is the presentation of unsupported opinion -- it cannot be educational.

Some tax-exempt organizations are clearly educational institutions. They include primary, secondary, and postsecondary schools, and colleges and universities. These institutions have the required "regularly scheduled curriculum, a regular faculty, and a regularly enrolled body of students in attendance at the place where the educational activities are regularly carried on." Other types of educational institutions include museums, planetariums, and symphony orchestras.

Education on just about any topic can be an exempt educational activity. This notion is essentially curbed only by notions of free speech and the public policy doctrine. Thus, the basic concept of *educational* as employed for federal tax law purposes is defined as relating to the "instruction or training of the individual for the purpose of improving or developing his capabilities" or the "instruction of the public on subjects useful to the individual and beneficial to the community."

Tax-exempt educational organizations are either public charities or private foundations (see Chapter 4).

Scientific Organizations

The Internal Revenue Code, the tax regulations, and IRS revenue rulings do not define the term *scientific* in the tax-exempt organizations' context. A court stated that the term *science* means the "process by which knowledge is systematized or classified through the use of observation, experimentation, or reasoning." A fundamental requirement underlying this form of tax exemption is that the organization must serve a public rather than a private interest. Thus, an exempt scientific organization must, among the other criteria for exemption, be organized and operated in the public interest.

With tax-exempt scientific organizations, the focus is primarily on the concept of *research*. For research to be scientific, it must be carried on in furtherance of a scientific purpose. Thus, the term *scientific* includes the carrying on of scientific research in the public interest. The term *research* is not well-defined in the law. For purposes of the unrelated business income rules, for example, it is necessary to determine whether the organization is operated primarily (see Chapter 1) for purposes of carrying on fundamental, as contrasted with applied, research. Scientific research does not include, however, activities ordinarily carried on incident to commercial operations, as, for example, the testing or inspection of materials or products or the designing or construction of equipment or buildings.

Scientific research is regarded as carried on in the public interest if the results of the research (including patents, copyrights, processes, or formulas) are made available to the public on a nondiscriminatory basis, if the research is performed for the U.S. or its agencies and instrumentalities or for a state or political subdivision of a state, or if the research is directed toward benefiting the public. An organization is regarded as not organized or operated for the purpose of carrying on scientific research in the public interest and, consequently, will not qualify as a scientific organization for federal tax exemption purposes if (1) it performs research only for persons who are, directly or indirectly, its creators and not charitable organizations; or (2) it retains, directly or indirectly, the ownership or control of more than an insubstantial portion of the patents, copyrights, processes, or formulas resulting from its research and does not make the items available to the public on a nondiscriminatory basis.

Tax-exempt scientific organizations are either public charities or private foundations (see Chapter 4).

Religious Organizations

With few exceptions, the IRS, other governmental agencies, and courts have refused to or been cautious in attempting to define *religious* activities or organizations, or the word *religion*. Constitutional law constraints (the First Amendment's Religion Clauses) play a major role in this regard.

The U.S. Supreme Court once grappled with the meaning of the term *religion*. It ventured the observation, authored well over a century ago, that the word has "reference to one's views of his relations to his Creator, and to the obligations they impose of reverence for his being and character, and of obedience to his will."

Subsequently, the Court wrote that the “essence of religion is belief in a relation to God involving duties superior to those arising from any human relation.” More recently, however, the Court stated that freedom of thought and religious belief “embraces the right to maintain theories of life and of death and of the hereafter which are rank heresy to followers of the orthodox faiths,” and that, if triers of fact undertake to examine the truth or falsity of religious beliefs, “they enter a forbidden domain.” The contemporary view among in the judiciary on the topic is perhaps represented by this statement: “Neither this Court, nor any branch of this Government, will consider the merits or fallacies of a religion,” nor will the court compare the beliefs, dogmas, and practices of a newly organized religion with those of an older, more established religion,” or “praise or condemn a religion, however excellent or fanatical or preposterous it may seem, because to do so “would impinge upon the guarantees of the First Amendment.”

Within the realm of religious organizations are churches (including synagogues and mosques). A definition of the word *church* does not appear in the Internal Revenue Code or in the tax regulations. The IRS, in 1974, made public criteria (14 points) to be considered in determining whether a religious organization is a church for federal tax purposes; only “some” of the criteria need to be followed. Matters in this regard have changed dramatically, however, with the

IRS drifting away from this multi-criteria approach and now insisting (in private letter rulings) that, for there to be an exempt church, there must be regular worship services conducted at a regular location with a regular congregation. (Thus, services by teleconference or online fail to qualify as church functions.) The IRS has been greatly aided in this regard by a court decision articulating a mandatory *associational test* as the standard for church status.

Other types of religious organizations recognized in the federal tax law are conventions and associations of churches, integrated auxiliaries of churches, mission societies, religious orders, apostolic organizations, communal groups, and retreat facilities.

Tax-exempt religious organizations are either public charities or private foundations (see Chapter 4).

Other Charitable Organizations

The realm of charitable organizations, from the standpoint of tax exemption, also includes organizations operating to prevent cruelty to children or animals, amateur sports organizations, organizations that test for public safety, cooperative hospital organizations, cooperative educational service organizations, charitable risk pools, and endowments.

Tax-exempt charitable organizations are either public charities or private foundations (see Chapter 4).

Endowments

An endowment fund is a form of investment fund; money and other property (usually derived from contributions or the organization's existing resources) are placed in and invested by means of the fund, some or all of the income of which is used by the organization to meet the cost of operations, including programs. These endowments are either part of an exempt organization or held in a separate organization. Endowments are true endowments, quasi-endowments, or term endowments. Tax-exempt colleges and universities may pay an excise tax on their net investment income.

Social Welfare Organizations

The federal tax law provides tax exemption for "[c]ivic leagues or organizations not organized for profit but operated exclusively for the promotion of social welfare." A precise definition of the term *social welfare* in this context does not exist; the tax regulations inform that social welfare is commensurate with the "common good and general welfare" and "civic betterments and social improvements."

The key principle is that, to qualify as an exempt social welfare organization, the activities of the entity must be those that benefit a community, rather than merely benefit the organization's membership or other select group of individuals or organizations. The IRS's expansive view of the concept of *community* is largely rested on a statement in a court opinion that an exempt social welfare organization must "offer a service or program for the direct betterment or improvement of the community as a whole." Thus, an organization that is functioning as a homeowners' association or a condominium association cannot qualify as an exempt social welfare organization, nor can a health care plan that is funded by subscribers. Some health maintenance organizations qualify for exemption under this category.

Again, the word *exclusively* means *primarily*. Lacking much law as to the quantification of exempt organizations' activities, the rule as to the determination of the requisite amount of exempt function activity for social welfare organizations is, at best, vague. It can also be controversial, as reflected in the current debate over the extent to which these organizations can engage in political campaign activity – and be tax-exempt.

Business Leagues

Federal income tax exemption is provided for "[b]usiness leagues . . . not organized for profit and no part of the net earnings of which inures to the benefit of any private shareholder or individual." A business league is more commonly known as a trade, business, or professional association. These entities almost always are membership organizations.

An exempt business league has six characteristics: it must be (1) an association of persons having a common business interest; (2) the purpose of which is to promote that common business interest; (3) that is not organized for profit; (4) that does not engage (other than incidentally) in a business ordinarily conducted for profit; (5) the activities of which are directed to the improvement of business conditions of one or more lines of business, as distinguished from the performance of particular services for individual persons; and (6) that is of the same general class as a chamber of commerce, board of trade, or the like.

Members of business leagues pay dues in exchange for services provided to them by the organizations. These services typically are or include conduct of annual conventions and educational seminars, development and distributions of publications, attempts to influence legislation germane to the members' common interests, presentation of information and opinions to government officials, conduct of public relations and community relations programs, engagement in research activities, operation of one or more certification programs, and conduct of trade shows.

Recent IRS private letter rulings that are adverse to organizations seeking recognition of exemption as business leagues focus on the fact that the entity is not primarily engaging in activities that improve business conditions in a line of business and/or that the entity is performing particular services to individual persons. The IRS may deny recognition of exemption to organizations that have a nonvoting membership, unless it can be shown that the members are meaningfully engaged in the organization's operations in other ways.

Labor Organizations

The principal purpose of a tax-exempt labor organization is to engage in collective action to better the working conditions of individuals engaged in a common pursuit. The most common example of the exempt labor entity is the labor union, which negotiates with employers on behalf of workers for improved wages, fringe benefits, and working conditions. Nonetheless, the exempt labor organization category encompasses a broader range of entities, including union-controlled organizations that provide benefits to workers that enhance the union's ability to bargain effectively, such as organizations providing strike and lockout benefits.

An organization generally cannot qualify as a tax-exempt labor organization if its principal activities are to receive, hold, invest, disburse, or otherwise manage funds associated with savings or investment plans or programs, including pension or other retirement savings plans or programs. For example, a trust organized pursuant to a collective bargaining agreement between a labor union and multiple employers that, as most of its activities, (1) receives funds from these employers, (2) invests the funds and uses them and accumulated earnings to pay retirement benefits to union members, (3) provides information to union members about their retirement benefits and assists them with administrative tasks associated with the benefits, and (4) participates in renegotiation of the agreement, cannot qualify as an exempt labor organization.

Social Clubs

The federal tax law provides exemption for qualified social clubs, that are "organized for pleasure, recreation, and other nonprofitable purposes, substantially all of the activities of which are for such purposes" and where the private inurement doctrine is not transgressed. Generally, this exemption extends to social and recreation clubs that are supported primarily by membership fees, dues, and assessments.

An exempt club is expected to have an established membership of individuals, personal contacts, and fellowship. Thus, for example, "clubs" that are formed solely to sidestep county liquor consumption restrictions and are indiscriminate as to admission of members are ineligible for exemption. A mingling of the members must play a material part in the operation of an exempt social club. (The federal tax law uses the word *comingling* but that is a redundancy.) It is for this reason that online clubs cannot qualify for exemption.

In general, no more than 15 percent of the gross receipts of a tax-exempt social club can be derived from use of club facilities or services by the public. Overall, an exempt club may not receive more than 35 percent of its gross receipts, including investment income, from sources other than its membership. These percentages are guidelines, so that they combine to be a safe harbor; if either or both percentages are exceeded, all of the facts and circumstances are taken into account in determining whether the organization nonetheless qualifies for exemption.

Where property used directly in the performance of a club's exempt function is sold and the proceeds reinvested in exempt function property, within a period beginning one year before the sale date and ending three years thereafter, any gain from the sale is recognized only to the extent that the sale price of the old property exceeds the purchase price of the new property.

Political Organizations

Federal tax exemption is available for the political organization, which is a party, committee, association, fund, or other organization organized and operated primarily for the purpose of directly or indirectly accepting contributions and making expenditures for an exempt function. In this context, an *exempt function* is the activity of influencing or attempting to influence the selection, nomination, election, or appointment of an individual to a federal, state, or local public office or office in a political organization, or the election of presidential or vicepresidential electors, whether or not these individuals or electors are selected, nominated, elected, or appointed. An expenditure by an exempt organization for an advocacy communication relating to a public policy issue may be for an exempt function.

Political organizations are subject to tax on their political organization taxable income. A political organization's taxable income is its gross income, less exempt function income and allowable deductions directly connected with the production of gross income (other than exempt function income). Exempt function income consists of amounts received as (1) contributions of money or property; (2) membership dues, fees, or assessments; (3) proceeds from a political fundraising or entertainment event; (4) proceeds from the sale of political campaign materials; and (5) proceeds from the conduct of bingo games.

If another type of tax-exempt organization expends an amount during a tax year for what would be a political organization exempt function, it must include in its gross income for the year an amount equal to the lesser of (1) its net investment income for the year or (2) the aggregate amount expended during the year for the exempt function. Charitable organizations engaging to any extent in political campaign intervention stand to have their tax exemption revoked, in addition to paying the political organization tax. The concept of political organization exempt function, however, is broader than the political campaign limitation, including, for example, an attempt to influence the appointment of an individual to a federal public office. Several types of exempt organizations can avoid this tax by causing the exempt functions to be conducted by a related political organization, such as a political action committee.

Because political organizations are required to disclose their donors and exempt social welfare organizations are not, the latter have become, in many instances, the preferred tax-exempt vehicle for engaging in political campaign financing activities.

Quasi-Governmental Entities

A statutory exclusion from the concept of gross income is available for entities that exercise an essential governmental function and where the income generated by that function accrues to a state or a political subdivision of a state. In its narrowest sense, the term *political subdivision* connotes a jurisdictional or geographical component of a state, such as a county, city, or sewer district. An entity may nonetheless be a division of a state without necessarily being a political subdivision of a state. Nonprofit organizations that are affiliated with a governmental unit may qualify for this classification. In this fashion, this tax exclusion provision operates as a tax exemption provision.

In the law, there are other principles that may be applied to this same end, namely, the doctrine of intergovernmental immunity (a rule implicit in the U.S. Constitution is that the federal government will not tax the states), classification as an integral part of a state or similar governmental entity, or classification as an instrumentality of a state. The IRS, however, rarely applies these principles today.

Other Types of Tax-Exempt Organizations

To be sure, there are many other types of tax-exempt organizations – 75 in all. These other categories of exempt organizations include instrumentalities of the U.S., title-holding companies, local associations of employees, agricultural organizations, horticultural organizations, chambers of commerce, boards of trade, real estate boards, professional sports leagues, fraternal beneficiary societies, voluntary employees' beneficiary associations, domestic fraternal societies, certain benevolent or mutual organizations, cemetery companies, state-chartered credit unions, certain insurance companies, crop operations finance corporations, veterans' organizations, high-risk individuals' health care coverage organizations, workers' compensation reinsurance organizations, health insurance issuers, farmers' cooperatives, shipowners' protection and indemnity associations, homeowners' associations, prepaid tuition programs, and ABLE programs.

Chapter 3: Tax Exemption

Exemption Recognition Process in General

As discussed, tax exemptions for nonprofit organizations must be the subject of a statute (see Chapter 2). Also, as discussed, in some instances, the tax law requires that tax exemption be recognized by the IRS (same chapter); this recognition occurs by issuance of a determination letter. The IRS annually promulgates procedures by which a determination letter may be issued to an organization in response to the filing of an application for recognition of exemption.

A determination letter recognizing tax-exempt status will be issued by the IRS to an organization only if its application for recognition of exemption and supporting documents establish that it meets the requirements of the category of exemption that it claimed. Tax exemption of an organization may be recognized by the IRS in advance of the organization's operations if the proposed activities are described in sufficient detail to permit a conclusion that the organization will clearly meet the pertinent federal tax law requirements. Courts reflect the view that an organization seeking a determination letter as to recognition of its tax-exempt status has the burden of proving that it satisfies all of the requirements of the particular tax exemption category.

IRS Forms

The IRS does certain things very well. One of them is creating tax forms. The IRS has created several forms in the application-for-recognition-of-exemption setting:

- Form 1023, which is the application usually filed by entities seeking recognition of exemption as charitable entities (see below)

- Form 1023-EZ, filed by smaller organizations seeking recognition of exemption as charitable entities

- Form 1024-A, filed by organizations seeking recognition of exemption as social welfare organizations

- Form 1024, filed by nearly all other types of nonprofit organizations seeking recognition of exemption

- Form 1028, filed by farmers', fruit growers', and similar organizations

- Form 1120-H, filed by homeowners' associations

A few types of nonprofit organizations seek recognition of exemption by means of filing of a letter.

Preparation of Application

The IRS, generally supported by the courts, usually will refuse to recognize an organization's tax-exempt status unless the entity tenders sufficient information regarding its operations and finances. In one instance, a court chided an organization for having only "vague generalizations" as to its ostensibly planned activities. Likewise, a court concluded that an organization failed to meet its burden of proof as to eligibility for exemption because it did not provide a "meaningful explanation" of its activities to the IRS. In another instance, a court concluded that an organization's failure to respond "completely or candidly" to many of the inquiries from the IRS precluded it from receiving a determination as to its exempt status. By contrast, a court observed that, although the law "requires that the [applicant] organization establish reasonable standards and criteria for its operation as an exempt organization," the rule does not necessitate "some sort of metaphysical proof of future events."

The proper preparation of an application for recognition of tax exemption involves far more than merely responding to questions on a government form. Every statement made in the application should be carefully considered. It is essential that all material facts be accurately and fully disclosed; of course, the determination of which facts are material requires judgment. The manner in which the answers are phrased can be significant; in this regard, the exercise can be more one of art than of science. The preparer or reviewer of the application should be able to anticipate the concerns that the contents of the application may cause the IRS. The application for recognition of exemption should be regarded as an important legal document for the applicant organization and prepared accordingly. The fact that the application is available for public inspection – assuming the applicant is successful – only underscores the need for thoughtful attention to it.

Exceptions

This requirement, generally imposed on prospective exempt charitable organizations, of filing an application for recognition of exemption is inapplicable to (1) churches, interchurch organizations of local units of a church, conventions and associations of churches, and integrated auxiliaries of churches; charitable organizations the gross receipts of which in each tax year are normally not more than $5,000 (as long as they are not private foundations or supporting organizations (see Chapter 4)); and subordinate organizations covered by a group exemption letter where the central organization has submitted to the IRS the requisite notice covering the subordinates.

Streamlined Application

In addition to the principal applications for recognition of exemption, the IRS has developed a streamlined (three-page) application for eligible organizations to use in applying for recognition of tax-exempt status as a charitable entity. This application – Form 1023-EZ – is available, with 23 exceptions, for organizations with gross receipts of no more than $50,000 and assets of no more than $250,000 (and thus are Form 990-N submitters). This $50,000 rule applies with respect to projected annual gross receipts in the current tax year or the next two years, or annual gross receipts that have exceeded $50,000 in any of the past three years.

This application does not require a statement of proposed activities or a projected budget. It essentially consists of a series of attestations as to federal tax law requirements. The application must be filed electronically.

Most types of nonprofit organizations of any consequence, in terms of type or size, are ineligible to file this application. The application may not be filed by (in addition to entities over the above thresholds) (1) organizations formed under the laws of a foreign country; (2) organizations that do not have a mailing address in the US; (3) organizations that are terrorist entities, or are successors to, or controlled by, a terrorist entity suspended from tax exemption; (4) organizations that are not corporations, unincorporated associations, or trusts; (5) organizations that are successors to a for-profit entity; (6) organizations that were previously revoked or are successors to a previously revoked organization (other than an organization that was revoked for failure to file or submit a Form 990 series return or notice for three consecutive years); (7) churches, conventions of churches, or associations of churches; (8) schools, colleges, or universities (9) hospitals or medical research organizations; (10) cooperative hospital service organizations; (11) cooperative service organizations of operating educational institutions; (12) qualified charitable risk pools; (13) supporting organizations; (14) organizations that have as a substantial purpose the provision of assistance to individuals through credit counseling activities, such as budgeting, personal finance, financial literacy, mortgage foreclosure assistance, or other consumer credit areas; (15) organizations that invest, or intend to invest, five percent or more of their total assets in securities or funds that are not publicly traded; (16) organizations that participate, or intend to participate, in partnerships (or entities treated as partnerships) in which they share profits and losses with partners other than exempt charitable organizations; (17) exempt charitable organizations that sell, or intend to sell, carbon credits or carbon offsets; (18) health maintenance organizations; (19) accountable care organizations or organizations that engage in, or intend to engage in, ACO activities (such as participation in the Medicare Shared Savings Program); (20) organizations that maintain, or intend to maintain, one or more donor-advised funds (see Chapter 4); (21) organizations that are organized and operated exclusively for testing for public safety and that are requesting public charity classification; (22) private operating foundations (same chapter); agricultural research organizations, and (23) organizations that are applying for retroactive reinstatement of exemption after being automatically revoked.

Form 1023 – A Tour

The IRS Form 1023 is a striking document; most (normal) individuals find it rather formidable. It is, for many, quite overwhelming; with its 14 core pages and 8 schedules, it is by far the most comprehensive of these applications. One of the most important aspects of this application, however, from a legal perspective, is the extent to which the IRS has packed the document with questions exploring nearly all aspects of the law of tax-exempt organizations. It is an application to be approached with respect, but not with fear.

I have helped organizations complete and submit this application and its predecessors for nonprofit applicants for over 50 years, on more occasions than I can recall. I regard preparation of this application from three angles. One, I consider the document as the equivalent of a for-profit company prospectus. Two, I keep in mind that a successful filing makes the application a public document (see Chapter 5) – looked at by prospective donors, the media, competitors, other federal and state regulators, and more. Three, I try to spot every legal issue lurking in the submission and look at it like an IRS reviewer does, anticipating the reviewer's questions. As to the last of those elements, my objective is to make the application "sing" – be so clear and through (what I think of as *pristine*) that there are no agent's questions (a goal that is tough to achieve).

This application for recognition of exemption filed by organizations seeking charitable status now must be filed electronically. This recent change in the law occasioned modification of the application, in part by embedding narrative responses to questions in the application itself, eliminating the need (and opportunity) for exhibits and copies of documents. Revisions have been made to the flow of the application, with many sets of questions reworked and/or expanded.

The core Form 1023 is divided into six parts. (The reader of this chapter would do well to have a copy of the application at hand.) Part I seeks basic information about the applicant. Most of the questions are clear and the answers obvious. Note, however, that the application seeks the organization's website address (question 8). This is important because the IRS reviewer will visit the site, looking for inconsistencies between the content of the application and on the site, and for material on the site that is not in the application. The organization's trustees, directors, and/or officers are listed in this part (question 9).

A lawyer or other tax professional is not needed in connection with this filing (although, from here, that is recommended). If an advisor is involved, a power of attorney (IRS Form 2848) must be filed on his or her behalf).

Part II focuses on the applicant organization's form (discussed in Chapter 2). The application states that if the applicant is not a corporation, a trust, an unincorporated association, or a limited liability company, it cannot be tax-exempt. This part also inquires about bylaws and asks whether the applicant is a successor to another organization. Concerning the latter, the IRS is taking a hardline (and incorrect) stance in this setting where the predecessor entity is or was a for-profit company.

Part III address application of the organizational test (discussed in Chapter 1). There, the applicant organization is expected to provide citations, in its articles of organization, to its statement of purposes and its dissolution clause.

Part IV references the required narrative of the applicant organization's past, present, and planned activities (question 1). This is the single most important aspect of the application. (See the above discussion about preparation of the application.) As to each activity, the following questions are to be answered: what is the activity, who conducts the activity, where is the activity conducted, what percentage of the applicant's total time is allocated to the activity, how is the activity funded and what percentage of overall expenses is allocated to the activity, and how does the activity further the applicant's exempt purposes?

Part IV also asks the organization to enter the National Taxonomy of Exempt Entities code that best describes its activities (question 2). These codes are found in Appendix D to the instructions for the application.

Part IV further includes several questions about the applicant's activities. The IRS asks about attempts to influence legislation and political campaign activities (questions 5 and 6) (see Chapter 1). The question about political campaign activity is a trap; if the answer is yes, the organization cannot be exempt as a charitable entity! A question asks whether any of the organization's programs limit the provision of goods, services, or funds to a specific individual or group of individuals; if the answer is yes, there likely is a private inurement or private benefit problem (question 3) (see Chapter 1). The same is true for the question concerning whether recipients of goods, services, or funds have a family or business relationship with any of the organization's trustees, directors, or officers, or with any of its highest compensated (over $100,000) employees or highest compensated independent contractors (question 4).

Still other questions in this part of the application inquire as to whether the applicant owns or have rights in intellectual property (question 7), provides information about credit counseling or personal finance (question 8), makes distributions to domestic or foreign organizations (questions 9-9i), operates in a foreign country or countries (questions 10-10c), maintains one or more donor-advised funds (question 11), operates a school (question 12), provides hospital or medical care (question 13), provides low-income housing (question 14), and provides educational grants to individuals (question 15).

This part of the application further asks questions about fundraising, which may strike some as odd inasmuch as there is little correlation between eligibility for tax exemption and whether and how the applicant engages in fundraising. If the organization undertakes fundraising, it is to identify the type or types of fundraising activities (e.g., solicitations by means of a website or mail, foundation grant solicitations, government grant solicitations, or gaming activities (question 16). A related question asks whether the organization engages in fundraising for other organizations (question 17).

Part V asks pointed questions about the applicant's compensation arrangements with its trustees, directors, officers, key employees, and independent contractors. Question 1 is straightforward, asking whether or not the applicant engages in the practice(s). If so, the IRS wants to know if the individuals that approve compensation practices follow a conflict-of-interest policy (question 1a), it approves compensation arrangements in advance of paying compensation (question 1b), it documents the date and terms of approved compensation arrangements (question 1c), it records the decision made by each individual who decided or voted on compensation arrangements (question 1d), has a basis for approving compensation (question 1e), and records the information or practices on which it relied to base compensation decisions and its source (questions 1f and 1g). Private inurement and excess benefits transactions issues (Chapter 1) lurk here.

There is a question about adoption of a conflict-of-interest policy (question 2, already asked in question 1a); these questions, plus the existence of a prototype policy in the instructions, illustrate the importance this policy has for the IRS. There are questions about non-fixed payments, such as discretionary bonuses or revenue-based payments (question 3); purchase or sale of goods and services among the persons (question 4); and leases, contracts, or loans with these persons or their controlled entities (question 5). The IRS asks whether the applicant contracts with another organization to develop, build, market, or finance its facilities (question 6).

Part VI seeks detailed financial data. The statement of revenues and expenses (Section A) ranges over five years: the current year and the four prior years or two succeeding years. How this financial data is presented depends on the number of years the organization has been in existence. If the organization has completed less than one year, it must provide financial information for its current year and reasonable and good-faith projections for the ensuing two years.

If the organization has been in existence less than five years, it should complete the financial statement for each year in existence and provide projections of its likely revenues and expenses, based on a reasonable and good-faith estimate of its future finances, for a total of the years of financial information and the other years of projections. If the organization has been in existence for five or more years, it should complete the schedule for the most recent five years. Part IX also includes a balance sheet (Section B).

Part VII concerns the organization’s public charity or private foundation status (see Chapter 4). The first question asks the applicant organization to state its public charity status or identify as a private foundation. If the entity is a private foundation, it must provide information about the organizational test that applies to private foundations (question 1a) (see Chapters 1, 4). Also, if the entity is a foundation, the applicant must explain whether it is a private operating foundation (question 1b) (see Chapter 4).

Part VIII relates to the effective date of the determination letter (if favorable). Generally, a determination letter recognizing tax exemption is effective as of the date of the organization's formation if it has filed the application within 27 months of the end of the month in which it was formed.

Part IX of the application pertains to the annual filing requirements. This part asks whether the organization is claiming to be excused from filing an annual information return or notice. If it is, the organization must identify the basis for the excusal.

In addition to the core Form 1023, there are 8 schedules. (Do not file a schedule if it is not needed.) These schedules are as follows:

- Schedule A – filed by churches seeking recognition of exemption (as discussed, churches can be tax-exempt without recognition)

- Schedule B – filed by schools, colleges, and universities

- Schedule C – filed by hospitals and medical research organizations
- Schedule D – filed by supporting organizations
- Schedule E – filed by organizations that are not submitting the Form 1023 within 27 months of formation
- Schedule F – filed by organizations providing low-income housing
- Schedule G – filed by successors to organizations
- Schedule H – filed by organizations providing scholarships, fellowships, educational loans, and/or other educational grants to individuals, and by private foundations requesting advance approval of their individual grant procedures

Applications Processing and Viewpoint Discrimination

The U.S. Supreme Court stated that, under the First Amendment, the government "has no power to restrict expression because of its message, its ideas, its subject matter, or its content." The Court added: "Content-based laws – those that target speech based on its communicative conduct – are presumptively unconstitutional and may be justified only if the government proves that they are narrowly tailored to serve compelling state interests." Earlier, the Court wrote that a "more blatant" and "egregious form of content discrimination" is viewpoint discrimination, which occurs when a government regulation "targets not subject matter, but particular views taken by speakers on a subject." Viewpoint discrimination is based on the "specific motivating ideology or the opinion or perspective of the speaker [,]and, therefore, "plainly offend[s]" the First Amendment.

As is the case with all government procedures, the process by which a nonprofit organization seeks recognition of tax-exempt status is required to comport with constitutional law principles. The principle usually implicated in this context is free speech, although equal protection and due process principles may be invoked.

As an illustration, a nonprofit organization asserted that the IRS had a special policy pertaining to applicant organizations that are concerned with Israel and have policies inconsistent with that of the administration. A lawsuit asserting that this policy constitutes viewpoint discrimination in violation of the First Amendment survived the federal government's motion to dismiss. An appellate court affirmed, observing that this organization is trying to "obtain relief from unconstitutional delay, the effects of which it is now suffering."

As another illustration, in connection with allegations that the IRS discriminated against applicant organizations on the basis of their political views, a consent order signed by court stated (1) "it is wrong to apply the United States tax laws . . . to any tax-exempt application or entity based solely on such entity's name, any lawful positions it espouses on any issues, or its associations or perceived associations with a particular political movement, position or viewpoint"; (2) "any action or inaction taken by the IRS must be applied evenhandedly and not based solely on a tax-exempt applicant or entity's name, political viewpoint, or associations or perceived associations with a political movement, position, or viewpoint"; and (3) "discrimination on the basis of political viewpoint in administering the United States tax code violates fundamental First Amendment rights."

Group Exemption

A nonprofit organization – such as a chapter, local, post, or unit – that is affiliated with and subject to the general supervision or control of a *central organization* – usually, a state, regional, or national organization – may be recognized as a tax-exempt organization solely by reason of its relationship with the parent organization. Exempt status acquired in this manner is referred to as tax exemption on a *group* basis. The advantage of this group exemption is that each of the organizations covered by a group exemption letter –

termed *subordinate organizations* – is relieved from filing an application for recognition of exemption.

The procedures by which a group exemption may be recognized by the IRS contemplate the functioning of the central organization as an agent of the IRS, requiring that the parent organization responsibly and independently evaluate the tax-exempt status of its subordinates from the standpoint of the organizational test and the operational test applicable to them. A central organization is required to annually file with the IRS a list of its qualifying exempt subordinates; this listing serves as an attestation by the central organization that the subordinate organizations qualify as exempt organizations.

Assuming that the general requirements for recognition of tax-exempt status are satisfied, a group exemption letter will be issued by the IRS to a central organization where (1) the foregoing requirements as to subordinate organizations are met, (2) the exemption to be recognized is under the general exemption rules, and (3) each of the subordinate organizations has an organizing instrument.

Thus, a central organization applying for a group exemption letter must first obtain recognition of its tax-exempt status and then establish that all of the subordinates to be included in the group exemption are (1) affiliated with it, (2) subject to its general supervision or control, (3) exempt under the same paragraph of the general exemption rules, (4) not private foundations or foreign organizations, (5) on the same accounting period as the central organization if they are to be included in group returns, and (6) formed within the 15-month period prior to the date of submission of the group exemption application.

A central organization must submit to the IRS, in addition to certain information about itself, the following information on behalf of its subordinates: (1) a letter signed by a principal officer of the central organization setting forth or including as attachments (a) information verifying the existence of the foregoing six relationships and requirements, (b) a detailed description of the principal purposes and activities of the subordinates, (c) a copy of a representative governing instrument adopted by the subordinates, (d) an affirmation that the subordinates are operating in accordance with the stated purposes, (e) a statement that each subordinate to be included in the group exemption has furnished the requisite written authorization, (f) a list of subordinates to be included in the group exemption to which the IRS has issued a determination letter, and (g) if relevant, an affirmation that no subordinate is a private foundation; and (2) a list of the names, addresses, and employer identification numbers of subordinates to be included in the group exemption.

Once a group exemption letter is issued, certain information must be submitted annually by the central organization, at least 90 days before the close of its annual accounting period, to the IRS to maintain the letter. This information consists of (1) information regarding any changes in the purposes, character, or method of operation of the subordinates; (2) lists of (a) subordinates that have changed their names or addresses during the year, (b) subordinates no longer to be included in the group exemption, and (c) subordinates to be added to the group exemption; and (3) the information summarized in the previous paragraph (items (1)(a)-(g)) with respect to subordinates to be added to the group exemption letter.

Notification Requirements

In two instances, an organization, to be tax-exempt, must file a notice with this IRS. A notice is different than an application for recognition of exemption.

A social welfare organization, no later than 60 days after its establishment, is required to notify the IRS that it is operating as such an entity. This body of law states the information that must be included in the notice (which is IRS Form 8976). An organization submitting this notification must include with its first annual information return (see Chapter 5) filed after submission of the notification any additional information prescribed by regulation that supports the organization's treatment as an exempt social welfare entity.

A penalty is imposed on an organization that fails to submit the notification, equal to $20 per day the failure continues, with a maximum of $5,000. A similar penalty is imposed on persons who fail to timely submit the notification in response to a request for it by the IRS.

Generally, for an organization to be treated as a tax-exempt political organization, it must give notice to the IRS of its existence. This notice must be transmitted no later than 24 hours after the date on which the organization is established. The notice must be submitted electronically. If this notice is provided after the 24-hour period, treatment of the entity as a tax-exempt organization is prospective, although the IRS has the authority to waive any tax resulting from a failure to comply with the notice requirement on a showing that the failure was due to reasonable cause and not to willful neglect. This law states the contents of the notice (IRS Form 8871).

This notice requirement is inapplicable in the case of (1) a political organization that reasonably anticipates that it will not have gross receipts of at least $25,000 for any year, (2) an entity required to report in accordance with federal campaign financing law as a political committee, and (3) any other type of tax-exempt organization that is subject to the political campaign activities tax.

Filing Requirements and Tax-Exempt Status

If a tax-exempt organization that is required to file an annual information return fails to file the return for three consecutive years, the organization's exempt status is revoked by operation of law. The same result occurs in connection with the non-filing of notices (e-postcards) and combinations of annual information returns and notices.

A revocation under these rules is effective from the date the IRS determined was the last day the organization could have timely filed the third required annual information return or notice. To have its tax exemption reinstated, the organization must apply to the IRS for recognition of exemption irrespective of whether it was originally required to make application for recognition. If, on application for recognition of exemption after an automatic revocation, the organization demonstrates, to the satisfaction of the IRS, reasonable cause for failing to file the required returns and/or submit the required notices, the organization's exempt status may, in the discretion of the IRS, be reinstated retroactively to the date of revocation.

The IRS published procedures for reinstatement of the tax-exempt status of organizations that had their exemptions revoked under these rules.

If an organization fails to file an information return or submit a notice for two consecutive years, the IRS is required to notify the organization of that fact and of the impending auto-revocation.

Chapter 4: Public Charity Status

Every tax-exempt charitable organization is either a public charity or a private foundation. Indeed, exempt charities are presumed to be private foundations (with that presumption rebuttable if it can be shown (usually to the IRS) that the entity qualifies as a type of public charity). Therefore, if the type of nonprofit you are starting is not going to be a charitable one (including educational, scientific, religious, and the like), you can skip this chapter.

Public Charities

A *public charity*, simply put, is a charitable organization that is not a private foundation. The vast number of exempt charitable organizations in the U.S. (about 1.5 million) are public charities. There are four basic categories of public charities: the institutions, publicly supported charities, supporting organizations, and organizations that test for public safety.

Institutions

This category of *public institutions* comprises churches, conventions and associations of churches, and certain other religious organizations; operating educational entities that normally maintain a regular faculty and curriculum, and normally have a regularly enrolled body of pupils or students in attendance at the place where the educational activities are regularly carried on (that is, school, colleges, and universities); hospitals and medical research organizations; agricultural research organizations; and governmental units, whether federal, state, or local.

Thus, these entities are public charities by virtue of their unique structures and programs.

Publicly Supported Charities – Introduction

As discussed below, one of the principal elements of a private foundation is that it is an entity generally funded from one source. The publicly supported organization is the antithesis of a private foundation in this regard: it is funded from many sources, with those sources of funding collectively regarded as the *public*.

There are two basic types of publicly supported charities: *donative* publicly supported charities and *service provider* publicly supported charities. (Public charity status is also accorded certain organizations providing financial support for public colleges and universities.) The principal difference between these two types of publicly supported charities is the manner in which they are funded.

These two classifications are somewhat oversimplified, in that most publicly supported charities receive financial support by means of a blend of gifts, grants, fee-for-service (or related) income, and investment income. The dual categorizations are helpful, nonetheless, in understanding the similarities of and difference between the two types of entities.

Donative Publicly Supported Charities

One of the principal types of publicly supported charities is the *donative publicly supported charity*, which is a charitable organization that normally receives a substantial part of its support (other than exempt function revenue) from one or more governmental units or from direct or indirect contributions or grants from the public. The principal requirement for a charitable organization to qualify as a donative public charity is that it normally derives at least one-third of its financial support from qualifying contributions and grants. The time span for measuring an organization's financial support is its most recent five years.

Public support in this context can come from any source: individuals, corporations, trusts, estates, partnerships, limited liability companies, and other tax-exempt organizations. But not all financial support is public support; there are limits. Essentially, a public support ratio is created, with all financial support (other than exempt function revenue) comprising the denominator of the fraction and the amount of qualifying forms of public support constituting the numerator. Based on the five-year measuring period, this type of charity qualifies as publicly supported if the fraction is at least one-third.

In general, contributions and grants constitute public support to the extent that the total amount of this type of support from a source during the five-year computation period does not exceed an amount equal to 2 percent of the organization's total includible support for the period. This tow-percent limitation does not apply, however, to support received from other donative organizations or from governmental units. Grants from these two sources is public support.

As an alternative, an organization can qualify as a donative publicly supported charity if it meets a facts-and-circumstances test. Investment income is never public support. Donors who have a defined relationship to one another (such as spouses and businesses and their sole owners) must share a single 2 percent limitation. Multiple contributions from any one source are aggregated over the support computation period.

These rules may become clearer if buttressed with an illustration. Suppose a charitable organization that received, during its most recent five years (e.g., for a calendar-year entity, 2020-2024), the total sum of gifts and grants of $400,000. Thus, to qualify as a donative publicly supported charity, its public support for the period must be at least $134,000 (one-third of $400,000, rounded). To determine if that goal was met, the charity created a public support ratio, applying the 2-percent rule. Two percent of $400,000 is $8,000. Thus, as a general rule, support from a donor or grantor will be public support to the extent the amount of the support is no more than $8,000. For example, a donor who contributed $5,000 provided $5,000 in public support, while a donor who gave $10,000 provided $8,000 in public support. Funds from other donative charities or government entities (if grants) are not limited by the 2-percent rule.

Someone must sift through the charity's financial records, evaluating each gift and grant in this fashion to determine if the minimum goal for the numerator (here, $134,000) was reached. For an organization with a large funding base, this is a considerable task. One outcome might be 15 donors who gave $8,000 each (for a total of $120,000) and a $20,000 government grant, resulting in $140,000 of public support – and satisfaction of the test (although life is rarely that simple).

These computations must be made on an ongoing basis (known as the *floating average*). A charitable organization that meets the public support test as of its current year is treated as a publicly supported charity for that year and the immediately succeeding year. For example, a calendar-year organization that meets the public support test for 2020, based on the five-year computation period 2016-2020, is a public charity for 2020 and 2021. If this organization cannot meet the public support test for 2021, based on the computation period consisting of 2017-2021, it nonetheless will be a public charity for 2021 because it met the test as of 2020. If, however, the organization cannot meet the public support test for 2022, the organization will become a private foundation as of January 1, 2023.

Many issues can arise in this setting. They include whether (1) the totality of support from an entity during the measuring period may be treated as public support, (2) a payment is a grant (and thus included in the support ratio) or made pursuant to a contract (excluded from the ratio), (3) a payment is from a source where the 2-percent cap is inapplicable, (4) a payment may be excluded from the ratio because it qualifies as an unusual (unexpected) grant or gift; (5) whether gifts from two sources must be combined and treated as from one source, and (6) the charity is eligible to use the alternative facts-and-circumstances test.

Service Provider Publicly Supported Charities

Another principal type of publicly supported charity is the *service provider publicly supported charity*, which must satisfy two fundamental tests. One of these tests requires that the charity normally receive more than one-third of its financial support from any combination of contributions, grants, membership fees, and/or gross receipts from admissions, sales of merchandise, performance of services, or furnishing of facilities in activities related to its exempt purposes, as long as the supported is from *permitted sources* (essentially, from persons who are not disqualified persons with respect to it). The second test requires that an organization normally receive not more than one-third of its support from the sum of gross investment income and any excess of the amount of unrelated business taxable income over the amount of tax imposed on that income.

Like the donative charitable organizations rules, the service provider organizations rules measure financial support over the entity's most recent five years and utilize a one-third support test. There are, however, some significant differences between these two sets of laws. For example, exempt function (related) income can count as public support for the service provider organization – but only to the extent that the revenue from any one source does not exceed the greater of $5,000 or 1 percent of the organization's support for the year involved.

The biggest difference between these two categories of publicly supported charities is in the manner of determination of public support. The 2-percent rule does not apply here. Instead, the rule is that public support is support from sources other than disqualified persons. *Disqualified persons* are the organization's directors (or trustees) and officers, key employees, members of their families, controlled entities, and substantial contributors. A *substantial* *contributor* is a person who contributes (or bequeaths or devises) more than $5,000, where that amount is more than 2 percent of total contributions and the like received by the organization since its inception. Again, investment income is not public support.

Here is an example (as similar to the previous one as possible) illustrating how these rules work. A charitable organization received, during its most recent five years (e.g., for a calendar-year entity, 2020-2024), the total sum of gifts and grants of $400,000. Thus, to qualify as a service provider publicly supported charity, its public support must be at least $134,000 (one-third of $400,000, rounded). To determine if that goal was met, the charity must subtract gifts and grants made by disqualified persons from the total of gift and grants.

In this setting, someone must sift through the charity's financial records, evaluating each gift and grant in this fashion to determine if the minimum goal for the numerator (here, $134,000) was reached. Here, the task is more formidable, more so the longer the charity has been in existence. Individuals are born, adopted, get married, get divorced, die; it can be a chore keeping up with all these doings. One outcome might be 15 donors, none of whom are disqualified persons, who gave $8,000 each (for a total of $120,000) and a $20,000 government grant, resulting in $140,000 of public support – and satisfaction of the test.

Issues that can arise in computing public support in this context, in addition to determining if a person is disqualified, is whether a payment is a gift or contract amount and/or is an unusual grant. Fee-for-service revenue is generally easy to identify. The facts-and-circumstances test is not applicable in this setting.

Supporting Organizations

The third way to be a public charity is to be a supporting organization. This is an entity that is related, structurally or operationally, to one or more of the institutions, publicly supported organizations, or certain noncharitable organizations (such as social welfare organizations, labor organizations, or business leagues). These beneficiary entities are referred to, not very imaginatively, as supported organizations.

A supporting organization must be organized and operated exclusively for the benefit of, to perform the functions of, or to carry out the purposes of one or more qualified supported organizations. The relationships must be operated, supervised, or controlled by; supervised or controlled in connection with; or operated in connection with one or more such organizations. These organizations are referred to as Type I, Type II, or Type III supporting organizations, respectively. Inasmuch as Type III supporting organizations are classified as functionally integrated ones or non-functionally integrated ones, there are four types of supporting organizations. A supporting organization may not be controlled, directly or indirectly, by one or more disqualified persons with respect to the organization (other than foundation managers and supported organizations).

Additional rules are applicable to Type III supporting organizations. This type of supporting organization must annually submit a notification report to its supported organization(s). It cannot support a foreign charity. It must satisfy a *responsiveness test*, which is done by demonstrating one of three close relationships among the trustees, directors, and officers of both entities and by showing that the supported organization has a significant voice in the operations of it. It must meet an *integral part test*, which basically means that it is significantly involved in the operations of the supported organization and that organization is dependent on the supporting organization for its support. Moreover, the integral part test is met by demonstrating that the functionally integrated supporting organization engages in qualifying activities, is the parent of one or more supported organizations, or is supporting one or more governmental entities. The integral part test is generally met by a showing that a non-functionally integrated supporting organization meets an attentiveness requirement and a mandatory payout requirement. Still other laws apply the excess business holdings rules to non-functionally integrated entities, place restrictions on private foundation grantmaking to non-functionally integrated entities, and preclude qualification as a Type III non-functionally integrated supporting organization if it is controlled by certain donors.

A supporting organization may operate to support and benefit a social welfare organization, a labor or agricultural organization, or a business league. The principal requirement in this regard is that the supported organization meet the one-third public support test of the rules concerning the service provider publicly supported charitable organization.

Supporting organizations can be used, for example, as a home for an endowment fund, a form of fundraising foundation, an entity in which programs may be conducted, a vehicle for holding property, an entity to receive large contributions so as to not disturb the parent's publicly supported charity status, or the basis by which a private foundation (see below) converts to a public charity.

Public Safety Testing Organizations

Certain organizations that test equipment and establish safety standards are tax-exempt and accorded public charity status.

Private Foundations Defined

From a statutory law perspective, a private foundation is a charitable organization that cannot qualify as a public charity. A charitable entity is presumed to be a private foundation; this presumption may be rebutted by a showing that the entity is a public charity. In this sense, the statutory definition of *private foundation* focuses on what is not a private foundation.

Aside from the statutory approach, a standard private foundation is an organization that fundamentally has four characteristics: (1) it is a tax-exempt charitable entity; (2) it is (almost always) funded from one source, such as an individual, married couple, family, or for-profit business; (3) its ongoing funding is in the form of investment income; and (4) it makes grants for charitable purposes, usually to public charities, rather than conduct its own programs. (There are about 90,000 private foundations.)

An entity that is somewhat of a hybrid between a private foundation and a public charity is the *private operating foundation*. This type of foundation conducts its own programs, rather than be a grantmaker.

One of the greatest services a lawyer or other professional helping a new charitable organization through the tax law maze can provide is steering the entity away from private foundation status – when possible.

Disqualified Persons

A basic concept of the tax laws relating to private foundations is that of the *disqualified person*. These persons are substantial contributors, foundation managers, an owner of more than 20 percent of an interest in an entity that is a substantial contributor, a member of the family of any of the foregoing persons, entities where more than 35 percent of the ownership interest is held by any of the foregoing purposes, and (in some instances) other private foundations and governmental officials.

Private Foundation Rules

The rules by which private foundations are regulated are underlain with penalty excise taxes. These sanctions entail three tiers of taxation, known as the initial tax, the additional tax, and the involuntary termination tax. In general, where there is a law violation, the initial tax must be paid; the additional tax is levied only when the initial tax is not timely paid and the matter is not timely corrected. The termination tax is levied when the other two taxes have been imposed and there continues to be willful, flagrant, or repeated acts or failures to act. The IRS has the authority to abate these taxes (other than in the self-dealing context), where the taxable event was due to reasonable cause and not to willful neglect, and the event was timely corrected.

In general, the federal tax law prohibits (in the sense of taxation, correction, and ultimately confiscation of income and assets rules) acts of self-dealing between a private foundation and disqualified persons. These acts are sales or exchanges of property, leasing of property, lending of money or other extension of credit, furnishing of goods or services, payment of compensation, and transfers or inappropriate uses of income or assets. There are several exceptions, however, with the most notable allowing for compensatory arrangements where the payment is for personal services that are reasonable and necessary in carrying out the foundation's charitable purposes.

A private foundation is required to distribute, for each year, an amount equal to at least 5 percent of the value of the foundation's noncharitable assets. The amounts expended must constitute *qualifying distributions,* which essentially are grants for charitable purposes and reasonable administrative expenditures. These rules thus require valuation of the foundation's investment assets (which, of course, do not include assets used for charitable purposes).

Generally, a private foundation and its disqualified persons are permitted to hold no more than 20 percent of an interest in a business enterprise. This rule applies to stock in a corporation, units in a partnership, and other forms of holdings in business ventures. The term *business enterprise* does not include a business that is functionally related to exempt purposes or an operation that derives at least 95 percent of its income from passive sources. Where it can be shown that control of the business is held by unrelated parties, the cap is as much as 35 percent. Impermissible holdings are known as *excess business holdings*.

A private foundation is subject to penalties if it invests any amount in a manner that would jeopardize the carrying out of any of its exempt purposes. The concept of a *jeopardizing investment* essentially means highly speculative investments. This rule does not apply to *program-related investments*, which are investments the primary purpose of which is to accomplish one or more charitable purposes. Usually, the rule also does not apply with respect to *mission-related investments*, which are investments that are consonant with the foundation's exempt purposes.

A private foundation is expected to avoid making *taxable expenditures*. These are amounts paid to carry on propaganda, influence legislation, electioneering, grants to individuals, and grants to noncharitable organizations. There are a range of exceptions to these rules, such as the conduct of voter registration drives, testifying before a legislative body pursuant to an invitation, the granting of scholarships and fellowships in accordance with an IRS-approved procedure, and circulation of the results of nonpartisan analysis, study, or research.

Private foundations must annually pay an excise tax on their net investment income. Rules apply to the processes by which foundations terminate their private foundation status, such as by becoming a public charity or transferring all income and assets to one or more public charities. The charitable giving rules (see Chapter 6) generally disfavor private foundations.

Donor-Advised Funds

Although the law does not set a minimum amount needed to fund a private foundation, it is an understatement to say that most persons do not have the wherewithal to establish a foundation. That fact, coupled with the formidable private foundation rules, means that most persons with some wealth and philanthropic intent do not form foundations. There is a vehicle for them, however: the donor-advised fund.

A donor-advised fund is a fund (essentially an account) (1) that is separately identified by reference to contributions by one or more donors, (2) that is owned and controlled by a sponsoring organization, and (3) as to which a donor or donor-advisor has advisory privileges with respect to the distribution and/or investment of amounts held in the fund by reason of the donor's status as a donor. A *sponsoring organization* is a public charity that maintains one or more donor-advised funds. A *donor-advisor* is a person appointed or designated by a donor to provide the advice.

Thus, a donor-advised fund is not a separate legal entity; it is a component (or unit) of the sponsoring organization. The tax exemption of these funds is thus derived from the exempt status of the managing organization. The sponsoring organization is required to make certain disclosures on its annual information return (see Chapter 5) about its donor-advised funds.

Sponsoring organizations today are generally of three types: community foundations, special-program entities, and organizations with a national scope affiliated with investment management companies.

The donor-advised fund is, then, a legitimate alternative to a private foundation. Donors relinquish control over the gift property when it is transferred to the sponsoring organization to be placed in the funds. But the donor does not have to incur the time and cost of starting a tax-exempt organization, selecting a board, filing for recognition of exempt status, maintaining an organization's operations, filing annual returns, and engaging in all of the other tasks and practices required in starting and running a nonprofit organization. But, with the ability to advise, the donor can make additional contributions to the fund and see to it that grants are made for charitable purposes. From that perspective, a donor-advised fund looks and functions much like a private foundation.

Chapter 5: Looking Ahead

This book is about starting a nonprofit, tax-exempt organization. Nonetheless, I have included this bonus chapter, to help you consider – as early into the process as reasonably possible – some law matters that you will need to attend to in preserving the existence and lawful operation of your organization.

Once you have obtained recognition of tax exemption or your organization is self-declaring, presumably you want to maintain the exemption. Generally, tax exemption is a valuable asset. Here are some considerations in connection with (prospective) loss of exempt status.

General Revocation of Tax-Exempt Status

In addition to the auto-revocation procedure (see Chapter 3), a determination letter recognizing tax exemption may be revoked – or modified – by a notice sent by the IRS to the organization involved, occasioned by one or more violations (actual or alleged) of the law concerning the exemption. Revocation may also occur because of a change in the law, namely, by enactment of legislation, a decision by the U.S. Supreme Court, issuance of regulations, or ratification of a tax treaty. Issuance of a revenue ruling, revenue procedure, or other statement published in the *Internal Revenue Bulletin* can also lead to revocation or modification of an exemption. In an instance of revocation or modification of a determination letter, the nonprofit organization involved can avail itself of appeal and conference procedures.

Retroactive Revocation of Exempt Status

The IRS has the authority, in appropriate circumstances, to retroactively revoke a determination letter as to an organization's exempt status. A determination letter concerning an exemption may be retroactively revoked – or modified – if the organization omitted or misstated a material fact, such as in the process of acquiring recognition of exemption or in an annual information return. Retroactive revocation may also occur if an organization operated in a manner materially different from that originally represented or engaged in a prohibited transaction.

Where there is a material change, inconsistent with tax exemption, in the character, purpose, or method of operation of an organization, revocation or modification ordinarily will take effect as of the date of the change. Indeed, revocation of exemption may be retroactive to the date of inception of the organization. Another way for a retroactive revocation to occur is a change in the law coupled with formal notice of the change by the IRS.

Thus, the IRS generally has the discretion as to whether to revoke an organization's tax exemption prospectively or retroactively. This discretion is broad; it is reviewable by the courts only for its abuse. Usually, a court will uphold the IRS's exercise of discretion to revoke an exemption retroactively. There have been two notable exceptions, however. In one case, a court decreed that the IRS lacked the authority to "arbitrarily and without limit" cause revocation of exemption "go[ing] back over previous years during which the taxpayer operated under the previous ruling;" the court refused to sustain this proposed "harsh result." More recently, a court ruled that the IRS abused its discretion in retroactively revoking the exempt status of an organization that, over the years, engaged in activities that were materially similar to those stated in its application for recognition of exemption.

Administrative Procedures Where Recognition Denied

The filing of an application for recognition of tax exemption with the IRS often leads to denial of the requested recognition. If the Exempt Organizations Division (Rulings and Agreements) concludes that the applicant organization does not satisfy the requirements for the exempt status being sought, the IRS generally will issue a proposed adverse determination letter. This letter will include a discussion of the IRS's rationale as to why the requested recognition should be denied.

This proposed adverse determination letter will also advise the organization of its opportunity to protest the determination by requesting consideration of the matter by the IRS Appeals Office. This appeal process requires the organization to submit a statement of the facts, law, and arguments in support of its position within 30 days from the date of the adverse determination letter. The organization must also state whether it wants an Appeals Office conference.

If an organization does not submit, on a timely basis, a protest of a proposed adverse determination letter, a final adverse determination letter will be issued to it. This final determination will provide information about the obligation of the organization to start filing tax returns, as well as on disclosure of the proposed and final adverse determination letters.

If the organization timely submits a protest, EO Rulings and Agreements will review it. If Rulings and Agreements concludes that the organization qualifies for tax-exempt status, it will issue a favorable determination letter. If, however, Rulings and Agreements maintains its adverse position, it will forward the protest and case file to Appeals. If Appeals, having considered the protest, agrees with the proposed adverse determination, it will issue a final adverse determination letter or, if a conference was requested, contact the organization to schedule a conference. At end close of the conference process, Appeals will issue a favorable determination letter or a final adverse determination letter.

The opportunity to protest an adverse determination letter and to make use of Appeals conference rights is not available in instances of matters where delay would be prejudicial to the interests of the IRS, such as in cases involving fraud, jeopardy, or the imminence of expiration of a statute of limitations, or where immediate action is necessary to protect the interests of the federal government.

Litigation Procedures Where Recognition is Denied or Revoked

An organization, having exhausted its administrative remedies, facing denial of recognition of exemption, revocation of exemption, or similar adverse treatment by the IRS (such as loss of public charity status), has, if it wishes to litigate the matter, three options. One, it may petition the U.S. Tax Court for relief following issuance of a notice of tax deficiency. Two, it may pay a tax and sue for a refund in federal district court or the U.S. Court of Federal Claims following expiration of a statutory six-month waiting period. Three, the organization can seek a declaratory judgment pursuant to a procedure designed for tax-exempt organizations issues. The third of these choices is the most common.

Jurisdiction over cases involving this declaratory judgment procedure, which is available in connection with nearly all categories of tax-exempt organizations, is vested in the U.S. District Court for the District of Columbia, the U.S. Court of Federal Claims, and the U.S. Tax Court. This law created a remedy in a case of actual controversy involving a determination by the IRS with respect to (1) the initial qualification or classification of a nonprofit organization as a tax-exempt entity, (2) the continuing qualification or classification of a nonprofit organization as a tax-exempt entity, (3) the eligibility of an organization to receive tax-deductible contributions, (4) the qualification of an exempt charitable organization as a public charity (see Chapter 4), or (5) the qualification of an exempt charitable organization as a private operating foundation (same chapter). This remedy is available in the case of a failure by the IRS to make a determination as respects one or more of these issues.

A pleading may be filed in accordance with these rules "only by the organization the qualification or classification of which is at issue." Prior to utilizing this procedure, an organization must have exhausted all administrative remedies available to it within the IRS. For the first 270 days after a request for a determination is made, assuming the IRS has not acted within that period, an organization is deemed to not have exhausted its administrative remedies. Once this period has elapsed, the organization may commence an action for a declaratory judgment. If, however, the IRS makes an adverse determination during the period, an action may be initiated. Nonetheless, all actions under these rules must be undertaken within 90 days after the date on which the final determination by the IRS is made.

Tax-exempt organizations generally must – annually – file returns or submit notices. Here is a summary of these filing requirements.

Annual Information Returns

Nearly every entity that is a tax-exempt organization must file with or submit to the IRS some form of annual information return or notice. These documents are collectively known as the *Form 990 series*. These documents are:

- Form 990, filed by the larger exempt organizations
- Form 990-EZ, filed by modest-sized exempt organizations
- Form 990-N, submitted by small exempt organizations
- Form 990-PF, filed by private foundations (of all sizes) (see Chapter 4)
- Form 990-BL, filed by black lung benefit trusts
- Political organizations also file tax returns on Form 1120-POL
- Homeowners' associations file tax returns on Form 1120-H

The Form 990, including its 16 schedules, is an extraordinary document. A nonprofit lawyer cannot adequately represent clients without having considerable familiarity with this return. The IRS has crammed into this document questions relating to nearly all aspects of the law of tax-exempt organizations. Indeed, there are sets of questions that go beyond law areas. When advising a nonprofit client as to a transaction or arrangement, the nonprofit lawyer should always be thinking about how it will be reported on the return – and what that reporting will look like. The Form 990 is not merely akin to a tax return that principally requires the submission of financial information. A substantial amount of factual information must be communicated by sentences and paragraphs – and the nonprofit lawyer should be involved in writing or at least reviewing (before the return is filed) that text.

When the IRS substantially revamped the Form 990, in 2008, the agency stated that its revision of the return was based on various guiding principles, including enhancing transparency by providing the IRS and the public with a realistic picture of the filing organization and its operations, and promoting compliance with the federal tax law. The return is structured to influence and modify behaviors, particularly in connection with governance. The revised Form 990 introduced many new concepts in the law of tax-exempt organizations.

Generally, the Form 990 must be filed by organizations that are too large to file or submit the other returns or notice in the Form 990 series. However, sponsoring organizations with donor-advised funds, organizations that operate one or more hospital facilities, and controlling organizations must file Form 990. Supporting organizations are required to file either Form 990 or Form 990-EZ, depending on the level of gross receipts and asset value.

The two-page Form 990-EZ may be used by tax-exempt organizations that have gross receipts that are less than $200,000 and total assets that are less than $500,000 in value at the end of the reporting year. An exempt organization filing a Form 990-EZ may have to file one or more schedules that accompany the Form 990.

The private foundation annual information return – Form 990-PF – must be filed irrespective of the entity's level of gross receipts or asset value. Foundations must report information about their disqualified persons, compliance with the various private foundation rules, calculation of the tax on net investment income, and other activities.

A tax-exempt central organization is required to file an annual information return. Also, it may annually file a *group return* for two or more of its subordinate organizations. A group return may be filed where the subordinate organizations are affiliated with the central organization at the close of its annual accounting period, are subject to the general supervision or control of the central organization, and are exempt from taxation pursuant to the same federal tax law provision.

Tax-exempt organizations that are not required to file an annual information return because they have annual gross receipts that are normally less than $50,000 must, to remain exempt, furnish the IRS, annually and in electronic form, a notice – Form 990-N. This notice is not a *return*; the notice is not *filed* but is *submitted*. A significance of these distinctions is that the submission of this electronic notification – also known as the e-Postcard – does not start the running of the statute of limitations for assessment of tax.

Annual information returns and notices are due on or before the 15th day of the fifth month following the close of the tax-exempt organization's tax year.

With respect to returns filed in connection with tax years beginning after July 1, 2019, tax-exempt organizations must file electronically. Transitional relief, for up to two years, is provided for small organizations or other entities that the IRS determines will otherwise suffer "undue burden." For this purpose, a small organization is an entity the gross receipts of which for a tax year are less than $200,000 and the aggregate gross assets of which at the end of the tax year are less than $500,000.

Failure to timely file the appropriate annual information return, or failure to include any information required to be shown on the return, absent reasonable cause can give rise to a $20-per-day penalty, payable by the organization, for each day the failure continues, with a maximum penalty for any one return not to exceed the lesser of $10,000or 5 percent of the gross receipts for the year. An additional penalty may be imposed at the same rate and maximum of $10,000 on the individual(s) responsible for the failure to file, absent reasonable cause, where the return remains unfiled following demand for it by the IRS. A much larger penalty is imposed on organizations having gross receipts in excess of $1 million for a year; in this circumstance, the per-day penalty is $100 and the maximum penalty is $50,000. There is no monetary penalty for failure to submit the notice.

Reporting Exceptions

Churches (including an interchurch organization of local units of a church), their integrated auxiliaries, and conventions and associations of churches are not required to file annual information returns. Organizations, other than supporting organizations and private foundations, with gross receipts not normally in excess of $50,000 do not have to file annual information returns – although they are, as noted, required to submit notices. Among other filing exemptions are those for mission societies affiliated with churches, states and their political subdivisions, governmental units, and affiliates of governmental units.

Unrelated Business Income Reporting

Revenue and expenses associated with unrelated business activity by a tax-exempt organization must be reported to the IRS. This reporting is on IRS Form 990-T, which is a tax return, not an information return. Schedules of this tax return pertain to rental income, unrelated debt-financed income, investment income of organizations required to treat that type of income as unrelated business income, certain income from controlled organizations, exploited exempt activity income (other than advertising income), and advertising income.

Other Reporting

Most states require nonprofit organizations to file annual reports. These organizations are likely to be required to file annual reports in connection with the receipt of government contracts or private foundation grants.

Tax-exempt organizations are subject to a battery of disclosure requirements.

Application Disclosure Rules

An organization that has been recognized as a tax-exempt entity is generally required to make available for public inspection during regular business hours a copy of its application for recognition of exemption, and to provide a copy of this document to those who properly requests it. This disclosure obligation extends to any papers submitted in support of the application and any letter or other document issued by the IRS with respect to the application. Also subject to this disclosure rule are the notice and related materials filed by political organizations.

A tax-exempt organization must make its application for recognition of exemption available for public inspection at its principal office and, if the organization regularly maintains one or more regional or district offices having at least three employees, at each of its regional and/or district offices. Generally, an exempt organization must provide copies of the documents, in response to an in-person request, at its principal, regional, and/or district offices “immediately” on request. If the request is in writing, the organization has 30 days in which to respond.

If a tax-exempt organization denies an individual’s request for inspection or a copy of an application and the person wishes to alert the IRS to the possible need for enforcement action, he or she may send a statement to the appropriate IRS district office, describing the reason why the individual believes the denial was in violation of these requirements.

This disclosure obligation is inapplicable where the exempt organization has made the requisite documents *widely available* (that is, on the Internet) or where the request is part of a *harassment campaign*.

A person failing to allow inspection of an organization's application for recognition of exemption must, absent reasonable cause, pay $20 per day for each day the failure continues. A person who willfully fails to comply with these inspection or copying requirements is subject to a penalty of $5,000 with respect to each application.

Annual Information Return Disclosure Rules

In general, a tax-exempt organization is required to make available for inspection during regular business hours copies of the organization's three most recent annual information returns, and to provide copies of these returns to those who properly request them. This disclosure regime also applies with respect to the annual returns filed by nonexempt private foundations and nonexempt charitable trusts, as well as to reports filed by political organizations.

In general, these rules parallel the disclosure rules concerning applications for recognition of exemption. This encompasses rules concerning inspection of annual information returns copies of these returns. A person failing to allow inspection of an organization's annual information returns is subject to a penalty of $20 per day for each day the failure continues, absent reasonable cause, with a maximum penalty per return of $10,000. The *widely available* and *harassment campaign* exceptions are available in this context.

Unrelated Business Income Returns

Tax-exempt charitable organizations are required to make public their unrelated business income tax returns, in accordance with the rules concerning the public inspection and disclosure requirements applicable with respect to annual information returns.

IRS Document Disclosure Tax Rules

In general, the IRS is required to disclose the text of any of the agency's written determinations and any background file document relating to a written determination. A *written determination* is an IRS ruling, determination letter, technical advice memorandum, or Chief Counsel advice memorandum. The term *background file document* with respect to a written determination includes the request for the determination, any written material submitted in support of the request, and certain communications between the IRS and other persons. The IRS is required to redact certain information, such as person's names and trade secrets, before making these documents publicly available.

Applications for recognition of exemption and supporting materials filed by tax-exempt organizations, and IRS determinations with respect to these applications, must be disclosed by the IRS. At the request of an organization, information pertaining to trade secrets, patents, processes, style of work, or an apparatus may be withheld by the IRS if the disclosure would adversely affect the organization. The IRS may also withhold from public inspection information contained in supporting papers where public disclosure of the information would adversely affect the national defense.

Also open to inspection under these rules are technical advice memoranda. Further, these document availability rules are applicable to the notice that must be filed by political organizations to establish their tax-exempt status and to the reports they must file. The IRS is required to make publicly available, at its offices and on the Internet, a list of all political organizations that file a notice with the IRS, and the name, address, electronic mailing address, custodian of records, and contact person for each of these organizations. This information must be made available not later than five business days after the notice is received.

The excise tax return filed by private foundations (IRS Form 4720) is available to the public. This return, as filed by a person other than a private foundation, such as in the intermediate sanctions context, legislatives activities context, or the political campaign activities context, is, however, not disclosable.

Information or Services Disclosure

A penalty may be imposed if (1) a tax-exempt organization offers to sell or solicits money for specific information or a routine service for any individual that could be readily obtained by the individual without charge (or for a nominal charge) from an agency of the federal government; (2) the exempt organization, when making the offer or solicitation, fails to make an “express statement (in a conspicuous and easily recognizable format)” that the information or service can be so obtained; and (3) the failure is due to intentional disregard of these requirements. This penalty, which is applicable for each day on which the failure occurred, is the greater of $1,000 or 50 percent of the aggregate cost of the offers and solicitations that occurred on any day on which the failure occurred and with respect to which there was this type of failure.

IRS Disclosure to State Officials

In response to a written request by an appropriate state official, the IRS may disclose (1) a notice of proposed refusal to recognize an organization as a tax-exempt charitable entity; a notice of proposed revocation of exemption of a charitable organization; (3) the issuance of a proposed deficiency of certain taxes; (4) the names, addresses, and taxpayer identification numbers of organizations that have applied for recognition of exemption as charitable organizations; and (5) returns and return information of organizations with respect to which information has been disclosed pursuant to the foregoing four categories of disclosure. Disclosure or inspection is permitted for the purpose of, and only to the extent necessary in, the administration of state laws regulating charitable organizations, such as laws regulating exempt status, charitable trusts, charitable solicitation, and fraud.

On the written request of a state official, the IRS may make available, for inspection or disclosure, returns and return information of any other type of tax-exempt organization. These returns and return information are available for inspection or disclosure only for the purpose of, and to the extent necessary in, the administration of state laws regulating the solicitation or administration of the charitable funds or charitable assets of those organizations.

Other Disclosure Requirements

Two other disclosure requirements are discussed in the context of the federal law concerning the charitable deduction and fundraising regulation. They are the rules concerning the quid pro quo contribution disclosure rules and disclosure of the nondeductibility of gifts to noncharitable organizations.

If the nonprofit organization you have formed and qualified is a charitable entity, it is likely that you and your colleagues will be interested in the laws concerning charitable giving. If not, you can skip or skim this section.

Overall Charitable Deduction Regime

At the federal law level, there are three basic categories of charitable contribution deductions. One of these law categories provides for a charitable deduction to be utilized in computing taxable income. This deduction is generally available for individuals who itemize their deductions and corporations. (The Department of the Treasury estimated that as many as 90 percent of individual American taxpayers will no longer itemize.) The other two categories are for charitable deductions in the estate tax and gift tax contexts. Most state laws provide for one or more charitable deductions.

Concept of a Contribution

Basically, a *contribution* (or a gift) is a payment of money or transfer of other property in a transaction that is voluntary and is motivated by something other than consideration (which is something received in exchange for a payment). Thus, the income tax regulations state that a transfer is not a contribution when made "with a reasonable expectation of financial return commensurate with the amount of the transfer." That type of transaction is a purchase. A transaction can be partially a contribution and partially a purchase.

The U.S. Supreme Court observed that a contribution is a transfer motivated by "detached or disinterested generosity." The Court also characterized a contribution as a transfer stimulated "out of affection, respect, admiration, charity, or like impulses." Thus, the focus in this area for the most part is an objective analysis, comparing what the ostensible donor parted with to what (if anything) the ostensible donor received in return.

Occasionally, the IRS or a court will take into account donative intent. A congressional committee report stated: "The term 'contribution or gift' is not defined by statute, but generally is interpreted to mean a voluntary transfer of money or other property without receipt of adequate consideration and with donative intent." This statement continued: "If a taxpayer receives or is expected to receive a quid pro quo in exchange for a transfer to charity, the taxpayer may be able to deduct the excess of the amount transferred over the fair market value of any benefit received in return provided the excess payment is made with the intention of making a gift."

A federal court of appeals described the topic of what is a contribution rather starkly: This is a "particularly confused issue of federal taxation." The statutory law on the point, this court stated, is "cryptic," and "neither Congress nor the courts have offered any very satisfactory definition" of the term *contribution*.

Qualified Charitable Donees

Qualified donees, in the federal income tax charitable contribution context, are charitable, educational, scientific, and religious organizations; certain fraternal organizations; certain cemetery companies; most veterans' organizations; and federal, state, and local governmental bodies. (Yes, in this context, governments are charities.)

The definition of charitable donee is similar in the estate tax and gift tax settings. The gift tax exclusion available for contributions to tax-exempt organizations, however, also encompasses gifts to political organizations, social welfare and labor organizations, business leagues and similar organizations.

Gift Properties

A basic element in determining whether, or the extent to which, a charitable contribution is deductible is the nature of the property contributed. Basically, the distinctions are between outright giving and planned giving (see below), and between contributions of money and contributions of other property. In many instances, the federal tax law differentiates between personal property and real property, and tangible property and intangible property (such as securities).

The federal income tax treatment of gifts of property is dependent on whether the property is capital gain property. The tax law makes a distinction between *long-term capital gain* and *short-term capital gain*. Property that is neither long-term capital gain property nor short-term capital gain property is *ordinary income property*. The three terms are based on the tax law classification of the type of revenue that would be generated on disposition of the property. Short-term capital gain property is generally treated as ordinary income property. Consequently, the actual distinction in the law is between capital gain property (long-term capital gain property) and ordinary income property.

Capital gain property is a capital asset that, when disposed of, would give rise to long-term capital gain. For a disposition to result in long-term capital gain, the property must be held for a specified period, generally 12 months. Capital gain property typically is securities and real estate.

The charitable contribution deduction for contributions of capital gain property is often equal to the property's fair market value, which may have increased (appreciated) while the property was held by the donor, or at least initially computed using that value. Contributions of ordinary income property generally produce a deduction equivalent to the amount of the donor's cost basis in the contributed property. On occasion, a contribution by a corporation can be equal to twice the amount of the donor's cost basis in the donated property.

Percentage Limitations

The extent of charitable contributions that can be deducted for a tax year is limited to certain amounts, which for individuals (who itemize deductions) is a function of the donor's *contribution base*, which essentially is the amount of the individual's adjusted gross income. This level of annual deductibility is dictated by seven percentage limitations. These limitations are dependent on several factors, principally the nature of the charitable donee and character of the property contributed. Often, contribution amounts that exceed an annual contribution base can be carried forward and deducted in one or more subsequent tax years.

A limitation on deductibility of 60 percent of an individual's contribution base is available where the donor has contributed only cash and only to public charities.

There is a limitation on deductibility of 50 percent of the donor's contribution base (except where the sixth percentage limitation applies) for contributions of money and ordinary income property, where the donee is a public charity or a private operating foundation (see Chapter 4). If an individual makes contributes that exceed this 50 percent limitation, the excess generally may be carried forward and deducted in one or more subsequent tax years (maximum of five).

The third percentage limitation is 30 percent of the donor's contribution base for gifts of capital gain property, where the donee is a public charity or a private operating foundation. Any excess of contributions over this 30 percent limitation is subject to the carryforward rule. A donor who makes gifts of money and capital gain property to public charities or private operating foundations in any one year generally must use a blend of these percentage limitations.

The fourth percentage limitation allows a donor of capital gain property to a public charity or private operating foundation to use the 50 percent limitation, rather than the 30 percent limitation, where the amount of the contribution is reduced by all the unrealized appreciation in the value of the property. This election is usually made by donors who want a larger charitable deduction in the year of the contribution for a gift of an item of property that has not greatly appreciated in value.

The fifth and sixth of these percentage limitations apply with respect to contributions to private foundations and certain other charitable donees (other than public charities and private operating foundations), such as fraternal and veterans' organizations.

Under the fifth percentage limitation, contributions of money and ordinary income property may not exceed 30 percent of the donor's contribution base. The carryover rules apply; they blend with the first three of these percentage limitations.

The sixth percentage limitation is 20 percent of the contribution base for contributions of capital gain property to private foundations and certain other charitable donees. There is a carryforward for any excess deduction amount.

As to the seventh of the percentage limitations, in the case of an individual who is a qualified farmer or rancher for the tax year in which a qualified conservation contribution is made, a contribution deduction for that type of gift is allowable up to 100 percent of the excess of the contribution base over the amount of all other allowable contributions. Any excess may be carried forward for up to 15 years as a contribution subject to the 100 percent limitation.

Deductible charitable contributions by corporations (C corporations) in any tax year generally may not exceed 10 percent of pretax net income. Excess amounts may be carried forward and deducted in subsequent years (up to five). As to gifts by corporations, the federal tax laws do not differentiate between gifts to public charities and to private foundations.

In the case of a corporation (the stock of which is not publicly traded) that is a qualified farmer or rancher for the tax year in which a qualified conservation contribution is made, a qualified conservation contribution is allowable up to 100 percent of the excess of the corporation's taxable income. Any excess contribution may be carried forward for up to 15 years as a contribution subject to the 100 percent limitation.

A business organization that is a flow-through entity generates a different tax result when it comes to charitable deductions. A *flow-through entity* is an S corporation, a limited liability company, a partnership, or other form of joint venture. These organizations, when they make charitable contributions, cannot claim charitable contribution deductions. Instead, the charitable deduction is passed through to the shareholders or members on an allocable basis; they separately claim those deductions.

Twice Basis Deductions

Generally, when a corporation makes a charitable contribution of property from its inventory, the resulting charitable deduction cannot exceed an amount equal to the donor's cost basis in the contributed property. In most instances, this basis amount is small, being equal to the cost of producing the property. Under certain circumstances, however, corporate donors can obtain a greater charitable deduction for gifts of inventory items. Where the tests are satisfied, the deduction can be equal to the basis amount plus one-half of the appreciated value of the property. This deduction, however, may not exceed an amount equal to twice the property's cost basis.

Under the general rule for inventory, five requirements must be satisfied for this twice-basis charitable contribution deduction to be available: (1) the contributed property must be used by the charitable donee for a related use; (2) the contributed property must be used solely for care of the ill, needy, or infants; (3) the property may not be transferred by the donee in exchange for money, other property, or services; (4) the donor must receive a written statement from the donee representing that use and disposition of the contributed property will be in conformity with these rules; and (5) where the contributed property is subject to regulation under the Federal Food, Drug, and Cosmetic Act, the property must satisfy the Act's requirements on the date of transfer and for the previous 180 days. For these rules to apply, the donee must be a public charity. An S corporation cannot utilize these rules.

Similarly computed deductions are available for contributions of food and book inventory, and scientific property used for research.

Deduction Reduction Rules

A donor who contributes ordinary income property to a charitable organization must confine the resulting charitable contribution deduction to the amount of the donor's cost basis in the property. That is, this deduction cannot be based on the fair market value of the property at the time of the gift; it must be reduced by the amount that would have been gain (ordinary income) if the property had been sold.

A donor who contributes *capital gain property* to a public charity generally can compute the charitable contribution deduction using the property's fair market value at the time of the gift, with no taxation of the appreciation (the capital gain inherent in the property). If, however, a donor makes a contribution of capital gain tangible personal property to a public charity and the gift's use by the donee is unrelated to its tax-exempt purposes, the donor must reduce the deduction by an amount equal to the long-term capital gain that would have been recognized had the donor disposed of the property at its fair market value as of the date of the contribution.

If a donee charitable organization disposes of an item of tangible personal property for which a deduction of more than $5,000 was claimed within three years of the contribution, and the disposition is in a year following the gift, the donor must include as the donor's ordinary income the amount of the claimed charitable deduction that exceeds the donor's cost basis. This recapture rule includes reporting requirements and a penalty for failure to comply.

Generally, a donor who makes a gift of capital gain property to a private foundation must reduce the amount of the otherwise allowable deduction by the appreciation amount in the gift property. An individual, however, is allowed full fair market value in computing a contribution deduction for a gift of publicly traded securities to a private foundation.

These deduction reduction rules also apply to contributions of (1) a patent, copyright, trademark, trade name, trade secret, know-how, software, or similar property or an application or registration of this type of property, and (2) taxidermy property contributed by a person who prepared, stuffed, or mounted property or who paid or incurred the cost of the preparation, stuffing, or mounting.

Step Transaction Doctrine

Again, the general rule is that a contribution of capital gain property that has appreciated in value to a public charitable organization is deductible on the basis of the fair market value of the property, with the capital gain element inherent in the property not taxable to the donor. If, however, the donee charitable organization sells the property soon after the contribution is made, the donor may have to recognize, for federal income tax purposes, the capital gain element. This can happen when, under the facts and circumstances surrounding the gift, the donee was legally obligate to sell the gift property to a purchaser that was prearranged by the donor. This is the step transaction doctrine, pursuant to which two or more ostensibly independent transactions (here, the gift and subsequent sale) are consolidated and treated as a single transaction for federal tax purposes.

Bargain Sales

A bargain sale is a transfer of property to a charitable organization when the transaction is in part a sale or exchange of the property and in part a charitable contribution of the property. Basically, a bargain sale is a sale of an item of property to a charitable organization at a price that is less than the fair market value of the property; the amount equal to the fair market value of the property, less the amount that is the sales price, is a contribution to the charitable organization. There must be allocated to the contribution portion of the property the element of the adjusted basis of the entire property that bears the same ratio to the total adjusted basis as the fair market value of the contributed portion of the property bears to the fair market value of the entire property.

Gifts of the Use of Property

While a person may contribute to a charitable organization the right to use an item of property, such as a gift of the right to use vacation property for two weeks, there is no federal income tax deduction for this type of gift. This type of contribution is a gift of a partial interest in property (see below) which is not one of the forms of partial interests the gift of which gives rise to a charitable contribution deduction.

Gifts of Services

While a person may contribute services to a charitable organization, a federal income tax deduction is not available for this type of gift. Because the donor of services rarely takes the value of the services into income, to allow a charitable deduction for the contribution of the services to a charitable organization would be to allow a double deduction, which is also the case with respect to gifts of the use of property.

Conservation Contributions

Special federal tax rules pertain to contributions to charity of real property or interests in real property for conservation purposes. These rules are an exception to the general rule that there is no charitable contribution deduction for contributions of partial interests in property. This exception involves the *qualified conservation contribution*.

A qualified conservation contribution has three fundamental characteristics; it is a contribution of a qualified real property interest, to a qualified organization, exclusively for conservation purposes.

A *qualified real property interest* is one of the following: the donor's entire interest in the property (other than a mineral interest), a remainder interest, or a restriction (such as an easement), granted in perpetuity, on the use that may be made of the real property. For example, an easement agreement that permits the donors to change the property subject to the easement is not an agreement concerning a gift granted in perpetuity.

A *qualified organization* is a unit of government, a publicly supported charitable organization, or a supporting organization that is controlled by one or more of the foregoing three types of entities. In addition, an eligible donee is one that has a "commitment to protect the conservation purposes of the donation," and has the "resources to enforce the restrictions."

The term *conservation purpose* means preservation of land areas for outdoor recreation by, or for the education of, the public; protection of a relatively natural habitat of fish, wildlife, or plants, or similar ecosystem; preservation of open space, including farmland and forest land; and preservation of a historically important land area or a certified historic structure.

Other Special Rules

In addition to the foregoing, the federal tax law provides charitable contribution deduction rules concerning gifts of vehicles, gifts of intellectual property, gifts of S corporation stock, gifts of taxidermy, gifts of clothing and household items, gifts to donor-advised funds (see Chapter 4), and gifts of fractional interests in property. Still other law pertains to avoidance of penalties for certain transfers to charity from retirement accounts.

Gifts as Business Expense Deductions

A business expense deduction is not allowed for a contribution that would be allowed deductibility as a charitable gift were it not for the percentage limitations on charitable deductions. Likewise, a business expense deduction is not allowed for a contribution if any part of it is deductible as a charitable gift.

Nonetheless, contributions may be deductible as business expenses rather than as charitable gifts. Transfers of property to a charitable organization that bear a direct relationship to the transferor's trade or business and that are made with a reasonable expectation of commensurate financial return may constitute valid outlays of a trade or business, deductible as business expenses. Contributions to noncharitable organizations that bear a direct relationship to the donor's business and are made with a reasonable expectation of commensurate financial return may constitute allowable deductions as business expenses, as long as the contributions are not made for a nondeductible activity. Nondeductible activities are lobbying and political campaign activities.

Partial Interest Gifts

Most charitable contributions of property encompass all ownership of the property; the donor parts with all right, title, and interest in the property. A gift of a partial interest in property is, however, possible; this is a contribution of less than a donor's entire interest in an item of property.

As a general rule, charitable deductions for gifts of partial interests in property, including the right to use property (see above), are not available. There are significant exceptions to this rule, however, including (1) gifts made in trust form (using a split-interest trust (see below)); (2) gifts of an outright remainder interest in a personal residence or farm; (3) gifts of an undivided portion of a person's entire interest in property; (4) gifts of a lease on, option to purchase, or easement with respect to real property granted in perpetuity to a public charity exclusively for conservation purposes (see above); and (5) a remainder interest in real property granted to a public charity exclusively for conservation purposes.

Contributions of income interests in property in trust are basically confined to the use of charitable lead trusts. Aside from charitable gift annuities (see below) and gifts of remainder interests as referenced in the second and fifth of the foregoing exceptions, there is no charitable deduction for a contribution of a remainder interest in property unless it is in trust and is one of three types: a charitable remainder annuity trust, a charitable remainder unitrust, or a pooled income fund (see below).

Defective charitable split-interest trusts may be reformed by a court to preserve the charitable deduction, where certain requirements are satisfied.

Income and Remainder Interests

The most sophisticated forms of planned giving are based on the fundamentals of law concerning income interests and remainder interests. That is, planned giving entails forms of contributions of partial interests.

Every item of property is conceptually comprised of two types of interests – one or more income interests and one or more remainder interests.

An income interest within an item of property arises as a consequence of the income generated by investment or other use of the property. A person may be entitled to all the income produced by a property or perhaps some percentage or other portion of that income; that person is said to have the or an *income interest* in the property. Two persons (such as spouses) may have income interests in the same property; these interests may be held concurrently or consecutively. The *remainder interest* within an item of property is based on the projected value of the property, or the property produced by reinvestments, at a future date.

These interests are predicated on the value of the property, the age of the donor(s), and the period of time that the income interest(s) will exist. The actual computation is made by means of actuarial tables, usually those promulgated by the Department of the Treasury.

An income interest or a remainder interest in property may be contributed to charity but it is unlikely that a charitable deduction will be available for a charitable gift of an income interest in property. By contrast, the charitable contribution of a remainder interest in property is the mainstay of planned giving and will – assuming all of the technical requirements are satisfied – give rise to a (frequently sizeable) charitable deduction.

When a contribution of a remainder interest in property is made to a charitable organization, the charity will not acquire the property represented by that interest until the income interest has expired (which usually is when the or a donor has expired). The donor(s) receives the charitable deduction for the tax year in which the recipient charity's remainder interest in the property is established (and perhaps for carryforward years). When a gift of an income interest in property is made to a charity, the charity usually acquires that interest immediately and retains it until such time (perhaps measured by a term of years or a lifetime) as the remainder interest commences.

Basically, under the federal tax law, a planned gift must be made by use of a trust if a charitable deduction is to be available. (A major exception is the charitable gift annuity.) The trust used to facilitate a planned gift is known as a *split-interest trust* because it is the mechanism (figuratively speaking) for satisfying the requirements involving the two types of interests. That is, this type of trust is the medium for splitting the property into its component interests. Split-interest trusts are charitable remainder trusts, pooled income funds, and charitable lead trusts.

Introduction to Planned Giving

The term *planned giving* essentially means a charitable contribution of a remainder interest in an item of property or a set of properties, of considerable value. This property may be a large tract of real estate, a sizeable portfolio of securities, or a business. The contribution is *planned* in the sense that it is integrated into the donor's financial plan and estate plan.

A donor, wishing to meaningfully support a charitable organization, may be unwilling or unable to part with an item of property (as an outright gift), either because of a present or perceived need for the income that the property generates and/or because of the capital gains taxes that would be experienced if the property were sold by the donor. The planned gift is likely to be the answer in this situation, inasmuch as a donor may satisfy his or her charitable desires and yet continue to derive income from the property (perhaps more than the pre-gift yield). The donor receives a charitable deduction for the contribution of the remainder interest, which can reduce or eliminate tax on the income from the trust. There is no income tax imposed on the capital gain inherent in the property when disposed of by the trust. If the contributed property is not throwing off sufficient income, the trustee of the split-interest trust may sell the property and reinvest the proceeds in more productive property.

Charitable Remainder Trusts

The most widespread of the planned giving techniques involves a split-interest trust known as the *charitable remainder trust*. This term is essentially self-explanatory, being a trust by which a remainder interest destined for charity has been created. Each charitable remainder trust is designed to further the particular economic goals of the donor(s) involved, as well as their philanthropic objectives by designation of the remainder interest(s) for one or more charities.

A qualified charitable remainder trust must provide for a specified distribution of income, at least annually, to or for the use of one or more beneficiaries, at least one of which is not a charitable organization. The flow of income must be for one or more lives (of humans) or for a term of no more than 20 years, with an irrevocable remainder interest to be held for the benefit of the charity involved or paid over to it. The non-charitable beneficiaries are the holders of the income interests; the charity owns the remainder interest.

Ascertainment of the income interests in a charitable remainder trust is dependent on whether the trust is a *charitable remainder annuity trust* (CRAT) (where income payments are in a fixed amount, namely, an annuity) or a *charitable remainder unitrust* (CRUT) (income payments in an amount equal to a fixed percentage of the fair market value of the assets in the trust).

The income payout of these types of trust is subject to a 5 percent minimum. That is, the annuity must be an amount equal to at least 5 percent of the value of the property initially placed in the trust. Likewise, the unitrust amount must be an amount equal to at least 5 percent of the value of the trust property, determined annually. These percentages may not be more than 50 percent. Also, the value of the remainder interest in the property must be at least 10 percent of the value of the property contributed to the trust.

As to the charitable remainder unitrust, four variations of them are available, with the classification dependent on the nature of the income payout. The foregoing criteria essentially define the standard charitable remainder unitrust (SCRUT), also known as the *fixed percentage* CRUT. Two types of CRUTs are termed *income-exception* CRUTs. One of these types allows income payments to begin only once a suitable amount of income flows into the trust and then are paid inly prospectively – the *net income* CRUT (NICRUT). The other type of CRUT is like the NICRUT, except that this type of trust can make payments that can be make-up (or catch-up) payments made to make up for income deficiencies in prior years – the net income make-up CRUT (NIMCRUT). The fourth type of CRUT allows for a one-time conversion of a trust from NICRUT or NIMCRUT status to a SCRUT; this is quaintly referred to as the *flip* CRUT (or, if more miring in acronyms is wanted, the FLIPCRUT).

Both categories of tax-exempt charitable organizations – public charities and private foundations -- are eligible to be remainder beneficiaries of as many charitable remainder trusts as they can muster. The amounts of the charitable deductions will likely vary for the types of charitable entities, however, because of the percentage limitations.

Conventionally, once the income interest(s) expires, the assets in a charitable remainder trust are distributed to the charitable organization or organizations that is the remainder interest beneficiary or are the remainder beneficiaries. If the assets, or a portion of them, are retained in the trust, the trust will become a private foundation, unless it can qualify as a public charity (most likely as a supporting organization).

Pooled Income Funds

A donor to a pooled income fund, which is another type of split-interest trust, receives a charitable contribution deduction for giving the remainder interest in an item of property to charity. The contribution creates income interests in noncharitable beneficiaries; the remainder interest in the gift property is designated for the charity that maintains the fund.

The pooled income fund's basic instrument is written to facilitate gifts from an unlimited number of donors; thus, the essential terms of the arrangement must be established in advance for all participants. Each donor to a pooled income fund contributes an irrevocable remainder interest in the gift property to or for the use of an eligible charity. Each donor creates an income interest for the life of one or more beneficiaries, who must be living at the time of the transfer. The properties transferred by the donors must be mingled in the fund, to create the necessary pool of gifts.

Each income interest beneficiary must receive income from the fund at least once annually. Income beneficiaries receive their proportionate share of the fund's income. The dollar amount of the income share is based on the number of units in the fund by the beneficiary; each unit must be based on the fair market value of the assets when transferred.

A pooled income fund must be maintained by the remainder interest charitable beneficiary. The charity must exercise control over the fund; it does not have to be the trustee of the fund but it must have the authority to remove and replace the trustee. A donor or an income beneficiary of a pooled income fund may not be a trustee of the fund.

Unlike other forms of planned giving, utilization of a pooled income fund is restricted to certain categories of charitable organizations. Most types of public charities are allowed to maintain a pooled income fund; private foundations and certain other charities cannot.

Because of low interest rates, pooled income funds have fallen out of favor and are rarely used.

Charitable Lead Trusts

Most forms of planned giving have a common characteristic: The donor transfers to a charitable organization, usually by means of a split-interest trust, the remainder interest in a property and one or more noncharitable beneficiaries obtain the income interest. A reverse sequence may occur, however; that is the essence of the charitable lead trust. An income interest in property is contributed to a charitable organization; the remainder interest in the property is reserved to flow, at the expiration of the income interest, to the noncharitable beneficiary or beneficiaries.

Charitable Gift Annuities

Still another form of planned giving is the charitable gift annuity. Unlike most other forms of planned giving, this technique is not based on use of a split-interest trust. Rather, this arrangement is reflected in an agreement between the donor and the donee. The donor agrees to make a gift and the donee agrees to provide the donor (or someone else) with an annuity.

With one payment, the donor in this context is engaging in two transactions, namely, purchase of the annuity and the making of a charitable gift. The money in excess of the amount necessary to purchase the annuity is the charitable gift portion. Because of this duality inherent in the transaction, the charitable gift annuity transfer constitutes a bargain sale.

The annuity resulting from creation of a charitable gift annuity arrangement is a fixed amount paid at regular intervals. The precise amount of the annuity depends on the age of the annuitant, which is determined at the time the contribution is made.

A portion of the annuity is tax-free as a return of capital. Where appreciated property is given, there will be capital gain in relation to the appreciation that is attributable to the value of the annuity. If the donor is the annuitant, the capital gain can be reported ratably over the individual’s life expectancy. The tax savings occasioned by the charitable contribution deduction may, however, shelter the capital gain, that resulted from creation of a charitable gift annuity, from taxation.

Because the arrangement is by contract, all of the assets of the charitable donee are on the line for ongoing payment of the annuity. (With most planned giving techniques, the resources for payments to income beneficiaries confined to those in a split-interest trust.) That is why some states impose a requirement that charities establish a reserve for the payment of gift annuities.

Gifts of Life Insurance

Still another form of planned giving involves the contribution to charity of life insurance. A gift of life insurance is an excellent way for an individual who, at the time, has a relatively small amount of resources (such as a young individual) to make a major contribution to a charitable organization.

If the insurance on the donor's life is fully paid up, the donor will receive a charitable deduction for the cash surrender value or the replacement value of the policy. If premiums are still being paid, the donor receives a deduction for the premium payments made during the tax year. For these deductions to be available, the donee charity must be both the beneficiary of and owner of the insurance policy.

State law needs to be checked to determine whether a contribution of life insurance is valid because of the necessity of insurable interest, which is the requirement that the owner and beneficiary of the policy be more economically advantaged with the insured alive. This can be the case, with respect to a charitable donee, where the donor is a key volunteer or potential donor of other, perhaps larger, charitable gifts.

Charitable Giving Administrative Requirements

Various requirements relating to donor responsibilities and administration of a charitable giving program must be satisfied for the donor to be entitled to a charitable contribution deduction. That is, a donor may make a valid charitable gift and be otherwise entitled to a charitable deduction, only to have the deduction completely defeated because one or more of these requirements were not satisfied. These requirements entail donor recordkeeping rules, gift substantiation rules, appraisal rules, and donor reporting rules (all summarized next).

Donor Recordkeeping Rules

A federal income tax deduction for a charitable contribution of money, check, or other form of monetary gift is not allowed unless the donor maintains as a record of the contribution a bank record or written communication from the donee showing the name of the donee organization, and the date and amount of the contribution. A *monetary gift* includes a transfer of a gift card redeemable for cash and a payment made by credit or debit card, electronic fund transfer, an online payment service, or payroll deduction. The term *bank record* includes a statement from a financial institution, an electronic fund transfer receipt, a cancelled check, a scanned image of both sides of a cancelled check obtained from a bank website, or a credit card statement.

The donor must receive this documentation on or before the earlier of (1) the date when the donor files the original income tax return for the tax year in which the contribution was made or (2) the due date, including extensions, for filing the donor's original return for that year.

These requirements do not apply to a transfer of a monetary gift to a charitable remainder trust or to a charitable lead trust that is a grantor trust.

Gift Substantiation Rules

A federal income tax charitable contribution deduction is not allowed for a separate contribution of $250 or more unless the donor has written substantiation from the donee of the contribution in the form of a contemporaneous written acknowledgment. An acknowledgement satisfies this requirement if it includes the following information: (1) the amount of money and a description (but not value) of any property other than money that was contributed; (2) whether the donee organization provided goods or services (with exceptions) in consideration, in whole or in part, for any money or property contributed; and (3) a description and good faith estimate of the value of any goods or services involved or, if the goods or services consist solely of intangible religious benefits, a statement to that effect.

This type of acknowledgement is *contemporaneous* if the contributor obtains it on or before the earlier of (1) the date on which the donor filed a tax return for the tax year in which the contribution was made or (2) the due date, including extensions, for filing the return.

In the case of a noncash charitable gift of less than $250 by an individual, partnership, S corporation, or C corporation that is a personal service corporation or closely held corporation, there is no federal income tax charitable deduction unless the donor maintains for each contribution a receipt from the charitable donee showing the name and address of the donee, the date of the contribution, a description of the property in sufficient detail, and, if the gift is of securities, the name of the issuer, the type of security, and whether the securities are publicly traded. A charitable deduction is not allowed for a noncash charitable contribution of between $250 and $500 unless the donor substantiates the gift with a contemporaneous written acknowledgment.

In the case of an individual, partnership, S corporation, or C corporation that is a personal service corporation or closely held corporation, there is no charitable deduction for a contribution of property for which a deduction of more than $500 is claimed unless the donor meets certain requirements. This deduction is not allowed for a noncash charitable contribution of more than $500 but less than $5,000 unless the donor substantiates the contribution with a contemporaneous written acknowledgement and meets the IRS Form 8283, Section A, completion and filing requirements.

A completed Form 8283, Section A, includes the donor's name and taxpayer identification number, the name and address of the donee, the date of the contribution, and certain information about the contributed property. In the case of a contribution of a vehicle, the donor must attach a copy of the acknowledgement to the return on which the deduction is claimed.

More stringent requirements apply where the gift is of a used vehicle, such as an automobile, airplane, or boat.

Gift Appraisal Rules

Generally, there is no federal income tax charitable contribution deduction for a noncash charitable gift having a value of more than $5,000 unless the donor substantiates the contribution with a contemporaneous written acknowledgement, obtains a qualified appraisal prepared by a qualified appraiser, and files a completed Form 8283, Section B. This rule does not apply with respect to contributions of publicly traded securities, intellectual property, vehicles, and inventory.

Generally, a federal income tax charitable contribution deduction is not allowed for a noncash charitable gift of more than $500,000 unless the donor substantiates the contribution with a contemporaneous written acknowledgment, obtains a qualified appraisal prepared by a qualified appraiser, files a completed Form 8283, Section B, and attaches a copy of the appraisal to the return on which the deduction is claimed. Likewise, this rule does not apply in the case of contributions of publicly traded securities, intellectual property, vehicles, and inventory.

Donee Reporting Rules

A charitable donee also has reporting obligations in the charitable giving context; these obligations arise as part of reporting on annual information returns (see above). Principal donors must be identified, receipt of noncash gifts must be reported, and special events must be summarized.

Again, if the nonprofit organization involved is a charitable entity, you and your colleagues may well be interested in fundraising. If not, this section can be skipped.

Introduction to Charitable Fundraising Regulation

Regulation of fundraising for charitable purposes permeates federal and state law. Most states have charitable solicitation acts that provide this type of regulation. While there is no such law at the federal level, the federal tax law contains various rules concerning charitable fundraising.

Each state (and D.C. and local units of government) possesses the police power, enabling the state, and its political subdivisions and instrumentalities, to regulate the conduct of its citizens and others so as to protect its citizens' safety, health, and welfare. Generally, it is clear that a state can enact and enforce, in the exercise of its police power, a charitable solicitation act that requires a charity planning on fundraising in the jurisdiction to first register with, or secure a license or permit from, the state and subsequently file reports about the results of its solicitation; the act will likely have other regulatory components. The rationale is that charitable solicitations may be reasonably regulated to protect the public from deceit, fraud, or other unscrupulous obtaining of money or other property under the pretense that the property is being collected and expended for a charitable purpose. The federal government does not have the police power; it has only enumerated powers.

Nonetheless, constitutional law principles may operate to confine the reach of the police power. These precepts are freedom of speech, procedural and substantive due process, and equal protection under the law, as well as standards imposed by statutory law which bar exercise of the police power in a matter that is arbitrary.

As to the first of these principles, fundraising by charitable organizations is among the highest forms of free speech. The U.S. Supreme Court stated that government can regulate charitable fundraising (presumably as an exercise of police power) but "must do so by narrowly drawn regulations designed to serve those interests without unnecessarily interfering with First Amendment freedoms." The Court observed in another context that these laws must be crafted using a "precisely tailored means of accommodating the legitimate interests of the state." One of the types of law that has been struck down by the Court on this basis are bans on fundraising where fundraising costs are in excess of a percentage.

Charitable Solicitation Acts

State charitable solicitation acts typically broadly define a host of terms, such as *charitable*, *contribution*, and *solicit*. Use of the term *charitable* in this setting often refers to a range of activities and organization that is considerably broader than that embraced by the federal tax law.

A cornerstone of the state's charitable solicitation act is the requirement that a charitable organization that intends to solicit contributions from persons in that state must first apply for and acquire permission to undertake the solicitation. Charities soliciting contributions in more than one state must register not only in the state in which it is located but also comply with the law of each of the states in which it will be fundraising. Most of these laws also mandate annual reporting. There may be exemptions from some charitable solicitation acts for some or all of the laws' requirements. The most notable exemptions are for churches and their closely related entities, educational institutions, hospitals, and charities involved in small (the amount varies) solicitations.

Some of this regulation is applicable to a professional fundraiser (or similar term). The majority of the states define a *professional fundraiser* as a person who, for a fixed fee under a written agreement, plans, conducts, advises, or acts as a consultant, directly or indirectly, in connection with soliciting contributions for or on behalf of a charitable organization. This regulation may also extend to those who are *professional solicitors*, that is, persons who, for compensation, solicit contributions for or on behalf of a charitable organization, whether directly or through others, or a person involved in a fundraising process who does not qualify as a professional fundraiser. A few states impose disclosure requirements in connection with the process known as *commercial co-venturing* or *charitable sales promotions*, where a business announces to the public that a portion of the purchase price of a product or service will, during a stated period, be paid to a charitable organization.

Provisions of these laws may require written agreements between the parties (such as charity and professional fundraiser) and dictate their contents, or force charities to make certain disclosures on solicitation materials. Some charitable solicitation acts may embody a series of *prohibited acts*, such as a ban on fundraising for a charity without its consent or a prohibition on representations that organizations are charitable when that is not the case.

Charleston Principles

Charitable fundraising by means of the Internet is now commonplace, raising questions of law as to when a posting of a gift request on a charitable organization's website amounts to a *solicitation* for purposes of the states' charitable solicitation acts. The National Association of State Charity Officials developed guidelines (not law) for determining when an Internet charitable solicitation warrants prior registration. An entity that is domiciled in a state and uses the Internet to conduct charitable solicitations in that state must, according to the Principles, register in that state. The

Principles also delineate situations where a charity soliciting in a state in which it is not domiciled is or is not required to register.

Quid Pro Quo Contribution Rules

The federal tax law imposes certain disclosure requirements on charitable organizations that receive quid pro quo contributions. This type of contribution is a payment "made partly as a contribution and partly in consideration for goods or services provided to the payor by the donee organization." There is an exception for payments for intangible religious benefits.

Pursuant to this law, if a charitable organization receives a quid pro quo contribution in excess of $75, the organization must, in connection with the solicitation or receipt of the contribution, provide a written statement that (1) informs the donor that the amount of the contribution that is deductible for federal income tax purposes is limited to the excess of the amount of money or value of any other property contributed by the donor over the value of the goods or services provided by the organization, and (2) provides the donor with a good faith estimate of the value of the goods or services. A penalty may be imposed for violation of these requirements.

Fundraising Disclosure

Contributions disclosure rules are applicable to all types of tax-exempt organizations other than charitable entities; they are targeted principally at social welfare organizations. These rules are designed to prevent these noncharitable organizations from engaging in gift-solicitation activities under circumstances in which prospective donors will assume, or be led to assume, that the contributions are tax-deductible, when in fact they are not. These rules do not, however, apply to an organization that has annual gross receipts that are normally no more than $100,000.

Under these rules, each fundraising solicitation by or on behalf of a tax-exempt noncharitable organization must contain an express statement in a "conspicuous and easily recognizable format" that gifts to it are not deductible as charitable contributions for federal income tax purposes. A *fundraising solicitation* is any solicitation of gifts made in written or printed form or by television, radio, or telephone. Despite the clear reference in the statute to "contributions" and "gifts," the IRS interprets this rule to mandate the disclosure when an exempt noncharitable organization seeks funds, such as dues, from its members. Failure to satisfy this disclosure requirement can result in imposition of penalties.

Application of Unrelated Business Rules

Many fundraising practices possess the technical characteristics of an unrelated business (see Chapter 1). That is, fundraising activities can be trades or businesses, that are regularly carried on, and that are not efforts that are substantially related to the performance of tax-exempt functions. Some fundraising activities are seen by the IRS as commercial undertakings (same chapter).

This application of the unrelated business rules in the fundraising context certainly is not applicable to the general solicitation of contributions and grants. It is most likely to arise in connection with event fundraising. Most of these events, however, are not regularly carried on. Three of the exceptions from unrelated business taxation are directly applicable in the charitable fundraising setting: a business (1) in which substantially all of the work is performed for the organization by volunteers; (2) which consists of the sale of merchandise, substantially all of which has been received by the organization as gifts; and (3) consisting of the conduct of bingo games.

As an illustration of these points, the IRS concluded that an event, where vendors offer arts and crafts, and involving a farmers' market and refreshment booths, sponsored by a tax-exempt alumni association operating to provide financial and civic support to a public college, was an unrelated business. The IRS's lawyers rejected the association's contentions that the event is a substantially related activity because it has the potential for student recruitment, generating donors for the college, and endearing the college's alumni to that institution, and it lessens the burdens of government and relieves the distress of the elderly.

The day may come when your nonprofit organization develops the need for a subsidiary organization. If that day comes, I hope the following will be helpful. Even if the notion of a subsidiary seems farfetched, you may want to skim (or surf) this chapter to see if and when a subsidiary may be of use.

Reasons for Use of a Subsidiary

A nonprofit, tax-exempt organization can establish one or more subsidiaries; there certainly is nothing in the law prohibiting that practice. Yet, there is no federal tax statutory law that expressly authorizes the practice. Nonetheless, an exempt organization's ability to utilize a subsidiary is reflected in that body of law, such as the rules concerning supporting organizations (see Chapter 4) and pertaining to potential taxation to parents of income from subsidiaries.

A subsidiary may be a for-profit entity, a nonprofit taxable entity, or a tax-exempt entity. Usually, it is wholly owned. Thus, the IRS observed that an exempt organization can "organize, capitalize and own, provide services and assets (real and personal, tangible and intangible) to a taxable entity without violating the requirements for exemption, regardless of whether the taxable entity is wholly or partially owned." Indeed, the IRS acknowledged that the "number of subsidiaries or related entities an exempt organization can create for the purpose of conducting business activities is not set."

For the most part, the reason or reasons for establishing and utilizing a subsidiary is grounded in law. For example, it is common, if not sometimes essential, for an exempt organization to use a for-profit subsidiary to house one or more unrelated businesses that are too extensive to be operated within the organization without jeopardizing or losing the parent's exempt status. An exempt parent may want to use an exempt subsidiary to conduct a program that is better operated in a separate entity, hold property, and/or engage in fundraising. Utilization of either type of subsidiary may occur to insulate the parent entity from liability or to serve as proxy for the parent in a partnership or other type of joint venture. Still other reasons for use of a for-profit subsidiary is to enhance the ability to raise capital for the business and build equity in the enterprise, and to serve as a paymaster for one or more tax-exempt organizations.

Choice of Form

Just as you did when establishing your nonprofit organization, consideration should be given to choice of organizational form when establishing a for-profit subsidiary. Usually, the choice will be the C corporation, inasmuch as a corporation is the most common of the business forms, provides a shield against liability for management and the tax-exempt parent, and enables the exempt parent to own the subsidiary by holding all or at least a majority of its stock. S corporations are unlikely candidates because they are flow-through entities that only charitable organizations can own, albeit with unfavorable applications of the unrelated business law.

Control Element

Where the subsidiary is a for-profit corporation, the tax-exempt parent can own the entity and ultimately control it by owning the stock issued by the subsidiary in exchange for the capital contributed. The exempt organization parent as the stockholder can thereafter select the board of directors of the subsidiary corporation and, if desired, its officers.

If the subsidiary is structured as a nonprofit corporation, the tax-exempt parent can control the subsidiary by means of interlocking directorates. Or, the subsidiary can be a membership corporation, with the parent entity the sole member. It may be that the subsidiary will be structured as a nonprofit corporation that can issue stock, in which instance the exempt organization parent would control the subsidiary by holding its stock.

Attribution

For federal income tax purposes, a parent organization and its subsidiary are respected as separate legal entities as long as the purposes for which the subsidiary is formed are reflected in authentic business activities. By contrast, where the parent organization so controls the affairs of the subsidiary that it is merely the extension of the parent, the subsidiary may not be regarded as a separate entity for tax law purposes. If the parent entity is directly involved in the day-to-day management of the subsidiary, the establishment and operation of an ostensibly separate subsidiary may be regarded as a sham and thus ignored for tax law purposes.

Capitalization

The law as to capitalization of a for-profit subsidiary by a tax-exempt parent is skimpy. Generally, an exempt organization should, in capitalizing a subsidiary, only part with an amount of money and/or other resources that is reasonable under the circumstances and that can be rationalized in relation to amounts devoted to programs and invested in other manners. In some instances, a specific asset may be best utilized in an unrelated activity. The extent to which a for-profit corporation can be capitalized using exempt organization assets is particularly sensitive where the parent is a charitable entity.

Sharing of Resources

Generally, a tax-exempt organization and its for-profit subsidiary may share office facilities, equipment, supplies, and the like. All relevant costs should be allocated on the basis of actual use; each entity must pay fair market value for the resources used. A written resources-sharing agreement is advisable, particularly where the parent is a charitable entity.

Subsidiaries in Partnerships

A tax-exempt organization, particularly a charitable one, may wish to avoid endangering its exempt status because of involvement in a partnership (including a limited liability company) by using a taxable subsidiary to be the partner (particularly a general partner) in its stead. This can be an effective stratagem as long as all the requirements of the law as to the bona fides of the subsidiary are satisfied, including determination that the subsidiary is an authentic business entity. If, however, the exempt organization parent is intimately involved in the day-to-day management of the subsidiary, there may be attribution of functions, thereby frustrating this approach.

Revenue from Subsidiary

Generally, otherwise passive nontaxable income that is derived by a tax-exempt organization from a controlled taxable subsidiary is treated as unrelated business income (see Chapter 1). This rule does not apply to dividends. A special rule can shield interest, rent, annuity, or royalty payments made by a controlled entity to the controlling exempt organization if the amount involved is reasonable.

Liquidations

The general rule is that any gain or loss must be recognized by a subsidiary on distribution of its assets in liquidation as if the assets were sold to the tax-exempt parent at their fair market value. Nonrecognition treatment is available, however, where the property distributed is used by the exempt organization in an unrelated business immediately after the distribution; should the property subsequently cease to be used in an unrelated business the exempt organization becomes taxable on the gain at that time.

Charitable Organizations as Subsidiaries

It is common for a tax-exempt organization, that is not a charitable entity, to establish an auxiliary charitable organization to house charitable program and perhaps fundraising. This occurs most notably where the parent entity is an exempt social welfare organization or exempt business league. This is the case in part because the charitable entity often can qualify as a supporting organization (see Chapter 4). Nearly any other category of exempt organization can maintain a charitable subsidiary, such as labor organizations, social clubs, and veterans' organizations. Frequently, this form of bifurcation involves parents and subsidiaries, both of whom are charitable entities.

Tax-Exempt Subsidiaries of Charitable Organizations

A tax-exempt charitable organization may find use for a noncharitable, exempt subsidiary. This is likely to occur where a charitable entity, which is engaging in or planning to engage in an activity that may or would jeopardize its exempt status, spins off to or initiates that potentially disqualifying activity in a separate organization that qualifies under another category of exemption. For example, a charitable organization may be concerned about the extent of its legislative activities and thus elect to conduct them in an exempt social welfare organization. Or, an exempt charitable entity may operate a certification program in a business league.

Other Combinations of Exempt Organizations

There are combinations of tax-exempt organizations where none of the entities involved are charitable ones. The most common of these arrangements entails use of political action committees, title-holding corporations, and employee benefit funds.

My comments about subsidiaries (above) apply equally with respect to joint ventures. You never know.

Joint Ventures Basics

A court defined a *joint venture* as an association of two or more persons with intent to carry out a single business venture for joint profit, for which purpose they combine their efforts, property, money, skill, and/or knowledge. The concept of a joint venture thus subsumes use of partnerships and limited liability companies. Tax-exempt organizations can be members of joint ventures. An exempt organization can be involved in a joint venture in advancement of an exempt purpose. In some instances, a court or the IRS will characterize an arrangement between parties as a joint venture for tax law purposes, irrespective of the intent of the participants.

Whole-Entity Joint Ventures

Often, a joint venture involves members who contribute only a portion of their resources to the venture. With the whole-entity approach, a member transfers the entirety of its assets to the joint venture. This occurred where the contributing member was a tax-exempt organization (a public charity; the other member was a for-profit organization. If the exempt organization cedes control over the venture to the for-profit member who manages the day-to-day operations of the venture, the exempt organization will forfeit its exemption, pursuant to the doctrine of private benefit. This outcome can be averted if exception protections are in place to preclude the venture from being operated to serve private interests.

Ancillary Joint Ventures

With the ancillary joint venture, something less than primary operations of a tax-exempt organization is in the venture. The position of the IRS is that a public charity in this type of arrangement with a for-profit entity will not lose its tax-exempt status if the involvement is an insubstantial part of its total operations and that it will not be subject to unrelated business income taxation if the charity retains control over the partnership arrangement and operations that constitute one or more related businesses.

Aggregate Principle

The activities of a partnership, limited liability company, or other form of joint venture are, as a matter of law, deemed to be activities of the partners or members. From the perspective of the federal tax law, this rule is termed the *aggregate principle*. This principle applies for purposes of the operational test (see Chapter 1), in that the operations of a joint venture that includes a tax-exempt organization are attributed to the exempt organization where it is being evaluated pursuant to this test. Where the attributed activities are nonexempt functions, the result can be unrelated business or endangerment of exempt status.

Single-Member LLCs

The federal tax law recognizes single-member limited liability companies. A tax-exempt organization can be the sole member of an LLC. Generally, these LLCs are disregarded for federal income tax purposes; a disregarded LLC is considered a branch or division of its member owner. The exempt owner of a single-member LLC treats the operations and finances of the LLC as its own for purposes of the annual information return filing requirements.

Many manifestations of use of single-member LLCs exist. For example, a contribution to this type of LLC, assuming it is a disregarded entity, that was created or organized in or under the law of the U.S., a U.S. possession, a state, or the District of Columbia, and that is wholly owned and controlled by a U.S. charity is considered a deductible contribution having been donated to a branch or division of the charity; the charity is, for tax law purposes, the donee. Likewise, the IRS stated that a private foundation may make a grant for charitable purposes to a disregarded LLC, where the member is a pubic charity, and properly treat the transfer as a qualifying distribution.

I certainly do not want to end on a negative note but the topic of IRS examinations (audits) cannot be omitted. IRS examinations of tax-exempt organizations are infrequent but they are occurring.

General IRS Exempt Organizations Examination Practices

The IRS examines the activities and records of tax-exempt organizations. In general, the agency is authorized to ascertain the correctness of any return, make a return where none has been made, and determine the liability of any person for any internal revenue tax. To this end, the IRS may examine any books, papers, records, or other data that may be relevant or material to its inquiry; summon persons liable for tax and/or having possession of pertinent records to appear before a representative of the agency; produce books and records, and give relevant testimony; and take testimony of persons under oath when relevant or material to an inquiry.

The examiners are specialists in the law of tax-exempt organizations. The IRS's Tax Exempt/Governmental Entities Division establishes the procedures and policies for the initiation and conduct of exempt organizations examinations. These examinations are coordinated in the IRS Exempt Organizations Examination unit headquartered in Dallas, Texas.

Types of Examinations

Common among IRS examinations are *field examinations*, in which one or more IRS revenue agents review the books, records, and other documents and information of the tax-exempt organization under examination, at an IRS office or on the premises of the organization. An *office interview case* is one where the examiner requests review of an organization's records in an IRS office or perhaps in the office of the organization or its authorized representative. A *correspondence examination* involves an IRS request for information from an organization by letter, fax, or email communication. A *team examination program* case generally is one where the exempt organization's annual information return (see above) reflects total revenue or assets greater than $100 million (or, in the case of a private foundation, $500 million).

Advance Preparations

Theoretically, there is much that can be done to prepare for an IRS examination. In reality, most if not all of these steps will not be taken, inasmuch as they are too time-consuming and/or costly. Certainly, many types of documents can be reviewed in advance, including governing instruments and policies, books and records, publications (such as newsletters and journals), correspondence, contracts, annual information returns, and minutes (those of the board and committees).

Website content should be checked. The (rare) exempt organization that wants to do all it can to avoid an IRS audit or smooth the process once enmeshed in one should engage the services of a competent lawyer to conduct a legal audit.

Examination Procedures

Almost always, an IRS examination of a tax-exempt organization will focus on its documents and activities encompassed by one to three of the organization's tax years. In many instances, the IRS will set an initial conference. The revenue agent(s) conducting the examination will begin the process of collecting documents and other information. The formal procedure is for the IRS to seek this information by submitting to the exempt organization one or more *information document requests.*

A tax-exempt organization under audit is well-advised to select a team that is charged with overseeing the examination from the entity's standpoint. The organization should designate an individual to be the single point of contact for the examination. Because the IRS is likely to contact third parties, such as the organization's bank, the examination can lead to media attention; this then involves creating a communications and public relations strategy. The IRS may request facilities on the premises of the exempt entity, almost always will conduct interviews, and may seek a tour.

Many IRS examinations of tax-exempt organizations are focused on the entity's eligibility for ongoing tax-exempt status. The principal outcomes are retention of exemption, modification of exempt status, and revocation of exempt status. An issue for charitable entities may be public charity status. Other potential issues are unrelated business activities and imposition of an excise tax. Some of these items can be settled. An administrative appeal may be undertaken. The matter may ripen into litigation.

The IRS's Internal Revenue Manual details procedures for the agency's examinations of tax-exempt organizations. These procedures explain the processes for the pre-examination phase, types of examinations, examiner's responsibilities, use of closing agreements, the team examination program procedures, and more.

IRS EO Examination Guidelines

The IRS's Exempt Organizations Examination Guidelines detail the procedures the agency will follow and the substantive issues it will review in connection with the following types of tax-exempt organizations and activities: title-holding corporations, charitable organizations, public charities, nonexempt charitable and split-interest trusts, religious organizations in general, churches, private and charter schools, public interest law firms, educational organizations, social welfare organizations, local associations of employees, labor organizations, agricultural and horticultural organizations, business leagues, social clubs, fraternal beneficiary organizations, voluntary employees' beneficiary associations, teachers' retirement fund associations, benevolent or mutual organizations, cemetery companies, credit unions, small insurance companies or associations, crop operations finance companies, supplemental unemployment benefit trusts, veterans' organizations, black lung benefits trusts, apostolic organizations, political organizations, health maintenance organizations, gaming, and fundraising.

Church Audits and Inquiries

Special statutory rules govern federal tax inquiries and examinations of churches. A *church tax inquiry* may be commenced by the IRS only where an appropriate high-level US Treasury official reasonably believes that the organization may not qualify as a church, may be carrying on an unrelated trade or business, or may otherwise be engaged in nonexempt activities. A *church tax examination* is any examination, for purposes of making a determination as described in the church tax inquiry definition, of church records or of the religious activities of a church. Third-party summonses and examinations of members of the clergy in their individual capacity are not covered by the church audit rules.

Due to controversy as to the meaning of the phrase *appropriate high-level U.S. Treasury official*, the IRS proposed regulations defining the term. In the interim, there have been few church tax inquiries or examinations. The proposed regulations were issued in 2009; they remain to be issued in final form.

Compliance Checks

An overlay to the IRS's programs of examinations and audits of tax-exempt organizations is the agency's compliance checks program. These compliance checks, usually initiated by the mailing of a questionnaire to appropriate exempt organizations, focus on specific compliance issues. The IRS may publicly disseminate information resulting from a compliance check project. A compliance check inquiry can evolve into one or more IRS examinations.

Examples of past compliance check projects are IRS inquiries into the operations of tax-exempt hospitals, institutions of higher education, and community foundations; the levels and types of compensation provided by exempt organizations; involvement by public charities in political campaign activities; compliance by applicable exempt organizations in annual information return reporting of involvement in excess benefit transactions; and tax-exempt bonds recordkeeping compliance by exempt organizations.

More recently initiated compliance checks by the IRS include inquiries into extensive unrelated business activity and "high" fundraising costs (termed the *charitable spending initiative*), exempt organizations maintaining group exemptions, and certain *self-declaring* organizations. Because of institutional difficulties currently embroiling the exempt organizations function of the IRS, these initiatives faded; resumption of these and any other compliance check projects is unclear at this time.

Today, the term *compliance check* is used by the IRS to describe a "light" contact by the agency in connection with a reporting requirement or some other specific issue, to be corrected. A compliance check is not an examination.

Other Resources

Readers who want more information about starting (and managing) nonprofit organizations, from a law standpoint, have many book choices to consider. Here is a sampling of my books:

- For a nontechnical book on the subject, consider: *Starting and Managing a Nonprofit Organization: A Legal Guide, Seventh Edition* (John Wiley & Sons, 2017).

For books that go into considerably more law detail, here is a partial list.

- *The Law of Tax-Exempt Organizations, Twelfth Edition* (John Wiley & Sons, 2019*)

- *The Tax Law of Charitable Giving, Sixth Edition* (John Wiley & Sons, 2021*)

- *The Law of Fundraising, Fifth Edition* (with Alicia Beck) (John Wiley & Sons, 2013*)

- *The Tax Law of Private Foundations, Fifth Edition* (John Wiley & Sons, 2018*)

- *The Law of Tax-Exempt Healthcare Organizations, Fourth Edition* (with Tom Hyatt) (John Wiley &

Sons, 2013*)

- *Legal Responsibilities of Nonprofit Boards, Third Edition* (BoardSource, Washington, D.C.: 2019)

- *Tax-Exempt Organizations and Constitutional Law: Nonprofit Law as Shaped by the U.S. Supreme Court* (John Wiley & Sons, Hoboken, N.J.: 2012)

- *How To Be a Successful Philanthropist: Avoiding the Legal Pitfalls* (Dorrance Publishing Co., Pittsburgh, PA: 2018)

- *Nonprofit Law for Colleges and Universities: Essential Questions and Answers for Officers, Directors, and Advisors* (with Virginia Gross and Tom Schenkelberg) (John Wiley & Sons, 2011)

- *Nonprofit Law for Religious Organizations: Essential Questions and Answers* (John Wiley & Sons, 2018)

- *The Tax Law of Associations* (John Wiley & Sons, 2006)

- *IRS Audits of Tax-Exempt Organizations: Policies, Practices, and Procedures* (John Wiley & Sons, 2008)

- *Nonprofit Governance: Law, Practices & Trends* (with Virginia Gross) (John Wiley & Sons, 2009)

- *The Nonprofit Law Dictionary* (John Wiley & Sons, 2015)

- *Donor-Advised Funds: Law and Policy* (Dorrance Publishing Co., 2020)

(* supplemented annually)

If you would like to read about nonprofit law in poetry form, two books are available:
Beware the Commerciality Doctrine and Other Nonprofit Law Poetry (2017) and
Nonprofit Law Poetry: The Second Book (2018)
If you have an interest in what nonprofit lawyers think and do, please turn to: *A Nonprofit Lawyer* (2018)
These books are all published by Dorrance Publishing Company.

My newsletter, *The Nonprofit Counsel* (published by John Wiley & Sons), serves up nonprofit law summaries on a monthly basis. As of 2021, the newsletter will be in its 38th year.

ABOUT

Bruce R. Hopkins

Bruce Hopkins is a practicing lawyer, law professor, conference presenter, and author of more than 40 books and a monthly newsletter on nonprofit law that he has written for 36 years. Hopkins' decades of practicing nonprofit law have given him unique perspectives on this tricky business of properly starting a nonprofit organization.

For more information, books and resources about nonprofit law, visit:

www.brucerhopkinsbooks.com

To learn about Bruce R. Hopkins' law practice, visit: www.brucerhopkinslaw.com

All You Need to Know to Start a Nonprofit Organization

Individuals are constantly forming nonprofit organizations in the United States. Most of these organizations qualify for tax exemption. But, too often, mistakes are made. With this book, mistakes can be avoided, enabling you to concentrate on furthering your causes.

Nonprofit organizations are U.S. treasures. The nonprofit sector in this nation is home to nearly 2 million charitable and other nonprofit entities. Formation of a nonprofit organization is not that much different from starting a for-profit business. Both types of organizations should be taken seriously.

With these observations, in ***How to Start a Nonprofit Organization (Legally)***, nonprofit lawyer Bruce Hopkins explains each of the steps that should be taken to properly form a nonprofit organization. Bruce has helped hundreds of nonprofit organizations over his 50 years of law practice. He shares his experiences and insights in this unique guide.

- A nonprofit law primer to understand the laws to navigate;
- Understanding the 21 essential steps to form a nonprofit;
- A checklist of the ways your organization can be tax-exempt;
- Guidance about whether a charitable organization should be public or private;
- An inventory of resources to assure successful operations.

Bruce Hopkins is a practicing lawyer, law professor, conference presenter, and author of more than 40 books and a monthly newsletter on nonprofit law. His decades of practicing nonprofit law have given him unique perspectives on this tricky business of properly starting a nonprofit organization.

Visit: brucerhopkinslaw.com and brucerhopkinsbooks.com