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ROAD MAP TO TAX-EXEMPT ORGANIZATIONS

I. WHAT IS AN EXEMPT ORGANIZATION?

A. Overview.

Clients often come to attorneys or accountants stating that they wish to "form a nonprofit." This request brings into play a complex network of laws, and requires a number of important decisions about the type of entity to be formed. This outline is intended as a road map to the major issues in selecting an appropriate entity, and an informational source for existing organizations.

B. Terminology.

1. Nonprofit.

First, a word on terminology. The term "nonprofit" generally refers to a corporation formed under a state nonprofit corporation statute. States generally have one statute that governs for profit corporations and another that governs nonprofits. Nonprofit corporations formed in Washington are governed by the Nonprofit Corporation Act, Chapter 24.03 RCW.

2. Tax-Exempt.

A "tax-exempt" organization is one that the Internal Revenue Service ("IRS") has recognized as meeting certain tax law requirements for exemption from federal income tax. Most tax-exempt organizations are nonprofit corporations or charitable trusts. The fact that an organization is formed as a nonprofit corporation under state law does not by itself make it tax-exempt.

3. Charity.

The term "charity" is used generally to refer to a particular type of tax-exempt organization, one qualified for exemption under Internal Revenue Code Section 501(c)(3).¹ This type of organization, discussed in detail below, must be organized and operated exclusively for charitable purposes.

¹ All citations, unless otherwise noted, are to the Internal Revenue Code of 1986, as amended.

4. Foundation.

The term "foundation" has no specific legal definition and commonly refers to a charity that makes grants. The term "private foundation" refers to a particular type of Section 501(c)(3) organization, discussed in detail below.

C. State Law Formation.

1. Corporation.

State law determines the nature of the entity to be formed and governs its day to day operations. A Washington nonprofit corporation may be formed as a membership or nonmembership organization. Members may have voting rights, to the extent provided in the corporation's articles or bylaws. In either event, the corporation is governed by a board of directors or a board of trustees (the two terms are synonymous in this context).

2. Trust.

A tax-exempt organization may also take the form of a charitable trust, governed by a trustee or trustees. The majority of charitable trusts are created or funded by will at the donor's death.

D. Federal Tax Exemption.

1. IRS Application Required.

Just because an organization is formed as a nonprofit corporation under state law does not mean that it is exempt from federal tax or that contributions to it are deductible. In the majority of cases, it is necessary to file an application for tax-exempt status with the IRS, and to receive a "determination letter" granting the exemption. The application is made on IRS Form 1023 (for Section 501(c)(3) organizations) or 1024 (for other organizations). The first step is to determine the appropriate category of tax exemption.

2. Categories of Tax Exemption.

The Internal Revenue Code grants an exemption from federal income tax to over 25 different categories of organizations. Only the most common are discussed here. Specific requirements apply for qualification under each category, and the organization's intended activities will determine which category is most appropriate.

II. SECTION 501(c)(3) ORGANIZATIONS

A. Charitable Organizations Generally.

1. Tax Benefits.

The most favorable type of tax-exempt status is that conveyed by Section 501(c)(3). Organizations qualifying under this section enjoy two significant benefits:

- a. they are exempt from tax on their income (other than income from unrelated business activities); and
- b. contributions to these organizations are deductible for federal income tax purposes by the donor, subject to certain limitations. Contributions to organizations that qualify for tax exemption under other sections of the Internal Revenue Code generally are not deductible as charitable contributions (although they may be deductible as business expenses in some cases).

2. Purposes Must Be Exclusively Charitable.

Organizations qualifying under Section 501(c)(3) are often referred to as "charities." The tax law imposes special restrictions on these organizations in exchange for the tax benefits that they receive. A Section 501(c)(3) organization must be organized and operated exclusively for "religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition . . . or for the prevention of cruelty to children or animals." The vast majority of organizations that qualify under this section are organized for "charitable, religious [or] scientific" purposes. "Charitable" has been interpreted to include a wide variety of activities that benefit the general public, including relief of poverty, advancement of religion, education or science, lessening the burdens of government, defending civil rights and eliminating prejudice and discrimination. A charity's organizing documents must state that it is organized exclusively for one or more permissible purposes and must not authorize the organization to engage in activities that may further nonexempt purposes.

3. Prohibition Against Private Inurement.

The tax law provides that the net earnings of an organization qualified under Section 501(c)(3) must not "inure to the benefit" of any private individual. Private inurement occurs when a person who is an "insider" with respect to the organization, such as an officer or director, derives a benefit from the organization without giving something of equal value in return. The IRS may revoke an organization's tax-exempt status if inurement occurs. Inurement may arise in many ways. Some of the most common situations are set out below.

a. Compensation.

An organization may pay reasonable compensation to employees or others for services rendered. Excessive compensation, however, such as compensation that exceeds payments by other organizations for similar services, may result in inurement. As a general rule, a tax-exempt organization should not pay any person a salary that is calculated as a percentage of the organization's net earnings. All incentive compensation arrangements should be reviewed by legal counsel.

b. Amounts Paid or Received for Property or Services.

If an exempt organization purchases property or services for more than adequate consideration or pays rent in excess of fair market value, this may constitute private inurement. Conversely, if an exempt organization furnishes property or services without receiving adequate compensation, inurement may result. If the organization provides property or services for less than fair market value in the course of fulfilling its tax-exempt purposes (e.g., an orchestra performing free concerts), private inurement will not result.

c. Loans.

If an organization borrows money from an insider at an above-market rate of interest, or loans money to an insider without receiving adequate security or reasonable interest, this may also create inurement. (Washington state law also prohibits a nonprofit corporation from making loans to officers or directors. RCW 24.03.140.)

4. Prohibition Against Engaging in Political Activities.

A Section 501(c)(3) organization may not participate in any political campaign on behalf of (or in opposition to) any candidate for public office. This prohibition is absolute, and any violation is grounds for loss of exempt status.

5. Limitation on Lobbying Activities.

a. Generally.

"Political activity," i.e., engaging in campaigns for office, is distinguished from "legislative activity." An organization engages in legislative activity if it contacts legislators, or urges the public to do so, for the purpose of proposing, supporting or opposing legislation. A Section 501(c)(3) organization that qualifies as a public charity (described below) may do so only if those activities do not constitute a "substantial" portion of the organization's activities. If the IRS determines that a public charity has engaged in substantial legislative activities, the exemption may be denied or revoked. Other types of organizations, e.g., social welfare organizations qualifying under Section 501(c)(4), discussed below, are not subject to limitation on their legislative activities.

b. "Substantiality" Test for Public Charities.

It is unclear how much legislative activity will be deemed to constitute a "substantial" portion of an organization's activities. One court has held that the expenditure of more than five percent of an organization's "time and effort" for political activity constitutes "substantial" expenditures. Organizations should monitor their legislative activities with this in mind. Certain activities of public charities will not constitute legislative activities for purposes of the substantiality test. These include conducting research and publishing nonpartisan studies, so long as the communications do not directly encourage the recipient to take action with respect to specific legislation.

c. Section 501(h) Election for Public Charities.

Public charities may make an election under Section 501(h) to become subject to a more objective standard than the "substantiality" test. Section 501(h) provides a "safe harbor" expenditure limit for planned or potential legislative activities. As a general rule, an organization whose legislative expenditures do not exceed 10% of its total expenditures for exempt purposes will not exceed the applicable limit. In addition, the total amount spent in any one year may not exceed \$1,000,000. Excessive lobbying expenditures in a given tax year will result in an excise tax of 25% on the excess amount. If the organization exceeds its permitted expenditures by 150% over a four-year period, it will lose its tax-exempt status.

6. Assets Must Be Irrevocably Committed to Charitable Purposes.

A Section 501(c)(3) organization must ensure that its assets will remain dedicated to charitable purposes, even if the organization ceases to exist. Its organizing documents must provide that on dissolution or termination its assets will go to another charitable organization. Assets may not go to donors or board members on dissolution.

B. Qualification as a Public Charity.

1. Overview.

a. Distinction Between Public Charities and Private Foundations.

Within the Section 501(c)(3) classification, there are two distinct categories of organizations: "public charities" and "private foundations." A Section 501(c)(3) organization is presumed to be a private foundation unless it can demonstrate that it meets one of the tests for qualification as a public charity, described below. An organization seeking characterization as a public charity must formally request a determination of its status by the IRS. Section 508(b). Private foundations generally derive their financial support from a single family or corporation, or a small group of donors, while public charities receive broad-based support from the general public. Because of the lack of public

involvement in private foundations, they are subject to a number of excise taxes and special restrictions that do not apply to public charities.

b. Requirements for Public Charity Status.

There are essentially four tests for qualification as a public charity, all arising under Section 509. An organization qualifies as a public charity if it: (i) qualifies as a school, church, or hospital, or conducts certain other favored activities; (ii) receives a specific percentage of its support from gifts from the public ("donative organizations"); (iii) receives a specific percentage of its support from a combination of gifts and fees from its exempt activities ("service organizations"); or (iv) has a close relationship (e.g., through interlocking boards) with another public charity ("supporting organizations"). Some organizations may qualify under more than one of these tests. Each of these tests is described in detail below.

2. Organizations Conducting Favored Activities.

Section 501(c)(3) organizations in the following categories are granted public charity status on the basis of their activities alone: (1) churches; (2) educational organizations that normally maintain regular faculties and curriculum and regularly enroll students; (3) organizations that principally provide medical or hospital care or conduct medical education or medical research; (4) endowment funds organized and operated in connection with public colleges and universities; and (5) states, possessions, and territories of the United States or any of their political subdivisions (e.g., counties and cities), and the District of Columbia. An organization must meet additional criteria for qualification under each category.

3. Donative Organizations (Publicly Supported Organizations Under Section 509(a)(1) and Section 170(b)(1)(A)(vi)).

a. Generally.

A nonprofit organization may qualify as a public charity if it receives a "substantial" amount of its support from the general public or from governmental entities. Organizations qualifying under this test include museums, libraries, and community centers. There are two ways to meet the "substantial" public support test: (i) the "one-third test"; and (ii) the "facts and circumstances test."

b. "One-third Test."

To qualify under the "one-third test," an organization must normally receive at least one-third of its total support from the general public, governmental entities, or from a combination of the two. The IRS uses a four-year computation period (five years for new organizations) to determine whether an organization is "normally" publicly supported within the meaning of both the "one-third test" and the "facts and circumstances test." "Support"

for these purposes includes gifts, grants, contributions, membership fees, net income from unrelated business activities, and gross investment income. Support does not include receipts from tax-exempt activities. (Organizations generating the majority of their revenues from exempt activities will likely qualify under the "one-third/one-third test" of Section 509(a)(2), described below.)

c. "Facts and Circumstances Test."

To qualify under the "facts and circumstances test," an organization must normally receive at least one-tenth of its support from the government, the general public, or a combination of the two. In addition, the organization must show, on the basis of certain factors, that it is organized and operated to attract public and governmental support on a continuing basis. The factors include whether:

- (i) the organization's public support comes from a representative number of persons, rather than a single family;
- (ii) the organization's governing body represents broad public interests, rather than the interests of a limited number of donors;
- (iii) the service or facility directly benefits the general public;
- (iv) solicitations for dues-paying members (if any) are designed to enroll a substantial number of persons;
- (v) dues are fixed at rates designed to make membership available to a broad cross-section of the public; and
- (vi) the organization's activities will appeal to a broad segment of the public. The organization must also maintain a continuous and bona fide program for soliciting funds from the general public, or conducting activities to attract governmental or other public support.

d. Two Percent Donor Cap.

Under both the one-third test and the facts and circumstances test, support from the general public or governmental entities includes direct or indirect contributions from any individual, a trust, or a corporate donor. If, however, a contribution from any particular donor, other than a governmental entity or a public charity, exceeds 2% of the organization's total support, then only the amount up to 2% will be considered public support. Organizations that receive much of their funding from a few donors must pay careful attention to this restriction.

4. Service Organizations: "One Third/One Third Test" (Publicly Supported Organizations Under Section 509(a)(2)).

a. More Than One-Third Gifts and Fees.

The support test for service organizations is commonly referred to as the "one-third/one-third test," because the organization must receive more than one-third of its support from specific sources, and not more than one third from other sources. A service organization must normally receive more than one third of its support from a combination of gifts, membership fees, and gross receipts from fees for admissions and sales of property or services that are substantially related to its exempt purposes (e.g., concert ticket sales, or fees for counseling services). Although this test is similar to the "one third" and "facts and circumstances" tests described above, there are numerous distinctions. Organizations qualifying under this test include orchestras, alumni associations and other membership organizations, and exempt service providers.

b. Not More Than One-Third Investment Income.

The organization must not normally receive more than one-third of its support from gross investment income, such as interest and dividends, or from the conduct of a trade or business that is not substantially related to the organization's exempt purposes. Section 509(a)(2).

c. Exclusions and Caps.

All contributions from "disqualified persons," including substantial contributors and foundation managers, are excluded in calculating support from gifts. In computing the amount received from fees for exempt activities, amounts received from any one person (including a governmental entity) are includable only to the extent that they do not exceed the greater of \$5,000, or 1% of the organization's total support for the year. Treas. Reg. § 1.509(a)-3(a)(4)(b)(1).

d. Unusual Grants.

In certain circumstances where a donation is unexpected and unusually large, and would adversely affect the public support calculation, it may be possible to exclude the donation from the support calculation as an "unusual grant." Treas. Reg. § 1.509(a)-3(c)(3).

5. Supporting Organizations (Section 509(a)(3)).

a. Relationship to Supported Organization.

A Section 501(c)(3) organization may also qualify as a public charity by being a "supporting organization." A supporting organization is a separately incorporated nonprofit

entity that is affiliated with a public charity. This is an attractive option for avoiding private foundation status for an organization that has a good relationship with an existing public charity. A supporting organization must be "operated, supervised, or controlled by or in connection with" the affiliated public charity. Section 509(a)(3)(B). An entity may satisfy this requirement in one of three ways:

- (i) a majority of the officers, directors or trustees of the supporting organization may be appointed or elected by the governing body of the public charity. Treas. Reg. § 1.509(a)-4(g)(1);
- (ii) the same persons may control the two organizations. Treas. Reg. § 1.509(a)-4(h)(1); or
- (iii) the organization may be a supporting organization if it is "responsive" to, and an "integral part" of the public charity. This is the least restrictive test. The facts and circumstances of each relationship are important in determining whether this test is met, and should be reviewed by an attorney.

b. No Control by Disqualified Persons.

A supporting organization may not be controlled directly or indirectly by one or more "disqualified persons," other than a foundation manager or a Section 509(a)(1) or (2) organization. Section 509(a)(3)(c). A disqualified person for this purpose includes a substantial contributor to the foundation, family members of disqualified persons, and entities such as corporations and partnerships owned by disqualified persons. Section 4946(a).

C. Private Foundations.

1. Generally.

Any Section 501(c)(3) organization that does not qualify as a public charity is presumed to be a private foundation. Section 509. The primary advantage to private foundation status is that an organization can remain entirely within a particular family's or group's control. The price for this level of control is that the organization is subject to a number of excise taxes, reporting requirements, limitations on activities, investment and distribution requirements, and limitations on the deductibility of contributions, that do not apply to public charities.

2. Self Dealing.

A private foundation may not engage in any "self dealing" transaction. Section 4941. Prohibited transactions include the sale, rental or lease of property, the lending of money or providing services or compensation in a transaction with a "disqualified person," as defined

above. Substantial penalty taxes may apply to any individual who engages in an act of self dealing and to any foundation manager who approves the act. These rules do not preclude a private foundation from paying an officer or trustee reasonable compensation for services rendered to the foundation. Treas. Reg. § 53.4941(d)-2(d)(2).

3. Investment Excise Tax.

An excise tax of 2% or 1% will be levied on a private foundation's net investment income. Section 4940. A public charity, in contrast, is generally subject to tax only on net income from business activities that are unrelated to its exempt purposes.

4. Distribution Requirements.

A private foundation must distribute its "minimum investment return" annually. Section 4942. The minimum investment return is essentially 5% of the fair market value of the foundation's assets, other than any assets used directly in carrying out its exempt purposes. Section 4942(e). If a private foundation fails to make the required distribution for the year in question, then it will be subject to a tax of 15% on "undistributed income." Section 4942(a). A continued failure to distribute income will result in a penalty excise tax of 100% of the undistributed amount. Section 4942(b).

5. Prohibition Against Lobbying Activities.

A private foundation may not engage in legislative activities. Amounts spent to influence legislation will be treated as "taxable expenditures" and subject to a penalty tax. Section 4945(a), (d).

6. Jeopardizing Investments.

Penalty excise taxes also apply to any expenditures for investments that jeopardize the organization's charitable purposes, such as trading on the margin or investments in commodities futures. Section 4944.

7. Excess Business Holdings Limitations.

A private foundation is prohibited from owning more than 20% of any business enterprise, subject to limited exceptions. Section 4943. For these purposes, the business holdings of "disqualified persons," as defined above, may be aggregated with those of the foundation.

8. Deductibility of Contributions for Federal Income Tax Purposes.

While contributions to both public charities and private foundations are deductible, the limitations on deductions for contributions to private foundations are stricter. The deduction

for a cash contribution to a private foundation is limited to 30% of the individual donor's "contribution base," essentially adjusted gross income for the year, subject to certain modifications. Section 170(b)(1)(B). Any excess contribution amount may be carried forward for five years. Section 170(d)(1)(A). In the case of a cash contribution to a public charity, the annual deduction limitation is 50% of the individual donor's contribution base, with a five-year carry forward. Section 170(b)(1)(A). Depending on the relative amounts of the contribution and the donor's contribution base, it is frequently more advantageous for an individual to contribute to a public charity.

D. Private Operating Foundations.

Certain types of private foundations, known as private operating foundations and exempt operating foundations, are exempt from certain of the taxes and restrictions that apply to private foundations generally. An organization that operates its own programs, as opposed to making grant distributions, may qualify under one of these categories if it fails to qualify as a public charity.

III. OTHER CATEGORIES OF TAX-EXEMPT ORGANIZATIONS

A. Overview.

1. Application for Tax Exemption.

Organizations seeking to qualify for federal tax exemption under a section other than Section 501(c)(3) in some cases may not be required to file an application for exemption with the IRS, but as a general rule it is advisable to do so in any event in order to avoid future controversy. The application is made on IRS Form 1024.

2. No Deduction For Contributions.

While tax-exempt organizations qualified under provisions of the Internal Revenue Code other than Section 501(c)(3) are exempt from federal tax on their income, donations to them are not deductible as charitable contributions. Dues and other fees paid to such organizations may in some cases be deductible as a business expense.

B. Section 501(c)(4) Social Welfare Organizations.

1. Purposes.

Internal Revenue Code Section 501(c)(4) grants tax exemption to "civic leagues or organizations operated for the promotion of social welfare or local associations of employees." These are generally referred to as "social welfare organizations." Frequently the purposes of a Section 501(c)(4) organization resemble very strongly those of a Section 501(c)(3) organization. The principal difference between a Section 501(c)(3) and a

Section 501(c)(4) organization is often the extent to which the organization is involved in political or legislative activities.

2. Political Activities.

While a Section 501(c)(3) organization is prohibited from supporting or opposing any candidate for political office, a Section 501(c)(4) organization may engage in a limited amount of campaign activity. This should not be a primary purpose of the organization, however.

3. Legislative Activities.

Unlike a Section 501(c)(3) organization, a social welfare organization may engage in an unlimited amount of legislative (lobbying) activity.

C. Section 501(c)(6) Business Leagues and Chambers of Commerce.

1. Purposes.

An organization formed to advance the interests of a particular profession or industry may qualify for tax exemption under Section 501(c)(6). Such organizations are generally membership organizations. The organization's principal purpose must be to advance the interests of the group as a whole, and not to provide specific services directly to its members.

2. Private Inurement.

The prohibition against private inurement applies to Section 501(c)(6) organizations.

3. Political Activities.

A Section 501(c)(6) organization may engage in a limited amount of campaign activity.

4. Legislative Activities.

A Section 501(c)(6) organization may engage in unlimited legislative (lobbying) activity.

D. Section 501(c)(7) Social and Recreational Clubs.

1. Purposes.

A membership club that is organized and operated for pleasure and recreation, such as a hobby club, sports club, or country club, may qualify for exemption under this section. A club will not qualify if it discriminates on the basis of race, color or, with limited exceptions, religion.

2. Private Inurement.

The prohibition against private inurement applies to Section 501(c)(7) organizations. This means that the club's assets must be used to further the club's recreational or social activities, rather than for the benefit of a particular member.