

# CHAPTER 1

## Distinguishing Characteristics of Tax-Exempt Organizations

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The world of tax-exempt (or simply *exempt*) organizations includes a broad range of nonprofit institutions: churches, schools, charities, business leagues, political parties, schools, country clubs, and united giving campaigns all conducting a wide variety of pursuits intended to serve the public, or common, good. All exempt organizations (EOs) share the common attribute of being organized for the advancement of a group of persons, rather than particular individuals or businesses. Most EOs are afforded special tax and legal status precisely because of the selfless motivation behind their formation.

The common thread running through the various types of EOs is the lack of private ownership and profit motive. A broad definition of an EO is a nonprofit entity operated without self-interest to serve a societal or group mission that pays over none of the income or profit to private individuals—its members and governing officials.

Federal and state governments view nonprofits as relieving their burdens by performing certain functions of government. Thus, many nonprofits are exempted from the levies that finance government, including income, sales, and ad valorem and other local property taxes. This special status recognizes the work they perform essentially on behalf of the government. In addition, for charitable nonprofits, labor unions, business leagues, and other types of exempt organizations, the tax deductibility of dues and donations paid to them further evidences the government's willingness to forgo money in their favor. At the same time, deductibility provides a major fund-raising tool. For complex reasons, some of which are not readily apparent, all nonprofits are not equal for tax deduction purposes, and not all "donations" are deductible.<sup>1</sup> Similarly that portion of the dues a civic association or business league spends on lobbying activity may not be deductible.<sup>2</sup>

On the federal level, Internal Revenue Code (IRC) §501 exempts some 30 specific types of nonprofit organizations, plus pension plans (§401), political organizations (§527), homeowner's associations (§528), and qualified state tuition programs (§529), from income tax. Although exempt organizations are often perceived as charitable, many other types of nonprofits are classified as tax-exempt under the federal income tax code. Labor unions, business leagues, community associations, cemeteries, employee benefit societies, social clubs, and many other types of organizations are listed in IRC §501. Exhibit 1.1 contains the Internal Revenue Service (IRS) master chart listing all categories of exempt organizations and illustrates the wide variety.

For purposes of federal tax exemption, each category has its own distinct set of criteria for qualification. Chapters 2 through 10 discuss the requirements for the most common types, compare the categories, explain the attributes that distinguish them from each other, and consider instances in which they overlap. Chapter 11 presents the rather complicated rules governing the preferred type of §501(c)(3) organization—public charities. Those §501(c)(3)s unable to be treated as public because of their narrow funding sources, called *private foundations*, are subject to special sanctions, found in Chapters 12 through 17.

The always challenging task of applying for recognition of tax-exempt status is considered in Chapter 18. The information submitted must draw a picture of the prospective exempt organization both in words and in numbers to enable the IRS to perceive the fashion in which it will serve exempt purposes. Suggestions for answering those questions for which the import is not readily apparent can be found in a separate book of the author.<sup>3</sup>

<sup>1</sup> See Chapter 24.

<sup>2</sup> See Chapters 6 and 8.

<sup>3</sup> See J. Blazek, *IRS Form 1023 Tax Preparation Guide* (Hoboken, NJ: John Wiley & Sons, 2005).

**EXHIBIT 1.1 Organization Reference Chart**

Section of 1986 Code	Description of Organization	General Nature of Activities	Application Form No.	Annual Return to Be Filed	Contributions Allowable?
501(c)(1)	Corporations Organized Under Act of Congress (including Federal Credit Unions)	Instrumentalities of the United States	No Form	None	Yes, if made for exclusively public purposes
501(c)(2)	Title Holding Corporations for Exempt Organization	Holding title to property of an exempt organization	1024	990 <sup>1</sup> or 990-EZ <sup>8</sup>	No <sup>2</sup>
501(c)(3)	Religious, Educational, Charitable, Scientific, Literary, Testing for Public Safety, to Foster National or International Amateur Sports Competition, or Prevention of Cruelty to Children or Animals Organizations	Activities of nature implied by description of class of organization	1023	990 <sup>1</sup> or 990-EZ, <sup>8</sup> or 990-PF	Yes, generally
501(c)(4)	Civic Leagues, Social Welfare Organizations, and Local Associations of Employees	Promotion of community welfare; charitable, educational, or recreational	1024	990 <sup>1</sup> or 990-EZ <sup>8</sup>	No, generally <sup>2,3</sup>
501(c)(5)	Labor, Agricultural, and Horticultural Organizations	Educational or instructive, the purpose being to improve conditions of work, and to improve products and efficiency	1024	990 <sup>1</sup> or 990-EZ <sup>8</sup>	No <sup>2</sup>
501(c)(6)	Business Leagues, Chambers of Commerce, Real Estate Boards, etc.	Improvement of business conditions of one or more lines of business	1024	990 <sup>1</sup> or 990-EZ <sup>8</sup>	No <sup>2</sup>
501(c)(7)	Social and Recreation Clubs	Pleasure, recreation, social activities	1024	990 <sup>1</sup> or 990-EZ <sup>8</sup>	No <sup>2</sup>

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## EXHIBIT 1.1 (Continued)

Section of 1986 Code	Description of Organization	General Nature of Activities	Application Form No.	Annual Return to Be Filed	Contributions Allowable?
501(c)(8)	Fraternal Beneficiary Societies and Associations	Lodge providing for payment of life, sickness, accident, or other benefits to members	1024	990 <sup>1</sup> or 990-EZ <sup>8</sup>	Yes, if for certain Sec. 501(c)(3) purposes
501(c)(9)	Voluntary Employees' Beneficiary Associations	Providing for payment of life, sickness, accident, or other benefits to members	1024	990 <sup>1</sup> or 990-EZ <sup>8</sup>	No <sup>2</sup>
501(c)(10)	Domestic Fraternal Societies and Associations	Lodge devoting its net earnings to charitable, fraternal, and other specified purposes. No life, sickness, or accident benefits to members	1024	990 <sup>1</sup> or 990-EZ <sup>8</sup>	Yes, if for certain Sec. 501(c)(3) purposes
501(c)(11)	Teachers' Retirement Fund Associations	Teachers' association for payment of retirement benefits	No Form <sup>6</sup>	990 <sup>1</sup> or 990-EZ <sup>8</sup>	No <sup>2</sup>
501(c)(12)	Benevolent Life Insurance Associations, Mutual Ditch Associations, Mutual or Cooperative Telephone Companies, etc.	Activities of a mutually beneficial nature similar to those implied by the description of class of organization	1024	990 <sup>1</sup> or 990-EZ <sup>8</sup>	No <sup>2</sup>
501(c)(13)	Cemetery Companies	Burials and incidental activities	1024	990 <sup>1</sup> or 990-EZ <sup>8</sup>	Yes, generally
501(c)(14)	State Chartered Credit Unions, Mutual Reserve Funds	Loans to members	No Form <sup>6</sup>	990 <sup>1</sup> or 990-EZ <sup>8</sup>	No <sup>2</sup>
501(c)(15)	Mutual Insurance Companies or Associations	Providing insurance, other than life, to members substantially at cost	1024	990 <sup>1</sup> or 990-EZ <sup>8</sup>	No <sup>2</sup>
501(c)(16)	Cooperative Organizations to Finance Crop Operations	Financing crop operations in conjunction with activities of a marketing or purchasing association	No Form <sup>6</sup>	990 <sup>1</sup> or 990-EZ <sup>8</sup>	No <sup>2</sup>

501(c)(17)	Supplemental Unemployment Benefit Trusts	Provides for payment of supplemental unemployment compensation benefits	1024	990 <sup>1</sup> or 990-EZ <sup>8</sup>	No <sup>2</sup>
501(c)(18)	Employee Funded Pension Trusts (created before June 25, 1959)	Payment of benefits under a pension plan funded by employees	No Form <sup>6</sup>	990 <sup>1</sup> or 990-EZ <sup>8</sup>	No <sup>2</sup>
501(c)(19)	Post or Organization of Past or Present Members of the Armed Forces	Activities implied by nature of organization	1024	990 <sup>1</sup> or 990-EZ <sup>8</sup>	No, generally <sup>7</sup>
501(c)(20)	Group Legal Services Plan	Activities implied by nature of organization	1024	990 <sup>1</sup> or 990-EZ <sup>8</sup>	No <sup>4</sup>
501(c)(21)	Black Lung Benefit Trusts	Funded by coal mine operators to satisfy their liability for disability or death due to black lung diseases	No Form <sup>6</sup>	990-BL	No <sup>4</sup>
501(c)(22)	Withdrawal Liability Payment Funds	To provide funds to meet liability of employers withdrawing from a multi-employer pension fund	No Form <sup>6</sup>	990 or 990-EZ <sup>8</sup>	No <sup>5</sup>
501(c)(23)	Veterans Organizations (created before 1880)	To provide insurance and other benefits to veterans	No Form <sup>6</sup>	990 or 990-EZ <sup>8</sup>	No, generally <sup>7</sup>
501(c)(24)	ERISA Trusts	Created under §4049 of ERISA Act of 1974			
501(c)(25)	Title Holding Corporations or Trusts with Multiple Parents	Holding title and paying over income from property to 35 or fewer parents or beneficiaries	1024	990 <sup>1</sup> or 990-EZ <sup>8</sup>	No
501(c)(26)	State-Sponsored Organizations Providing Health Coverage for High-Risk Individuals	Provides health-care coverage to high-risk individuals	No Form <sup>6</sup>	990 <sup>1</sup> or 990-EZ <sup>8</sup>	No

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## EXHIBIT 1.1 (Continued)

Section of 1986 Code	Description of Organization	General Nature of Activities	Application Form No.	Annual Return to Be Filed	Contributions Allowable?
501(c)(27)	State-Sponsored Workers' Compensation Reinsurance Organizations	Reimburses members for losses under workers' compensation acts	No Form <sup>6</sup>	990 <sup>1</sup> or 990-EZ <sup>8</sup>	No
501(c)(28)	National Railroad Retirement Investment Trusts	Established under section 15(j) of the Railroad Retirement Act of 1974	No Form	None	No
501(c)(29)	Co-Health Insurance Issuers	CO-OP participants receiving loans or grants	No Form yet – IRS still working on guidance as of 9/2011.	990 <sup>1</sup> or 990-EZ <sup>8</sup>	No
501(d)	Religious and Apostolic Associations	Regular business activities; communal religious community	No Form	1065 <sup>9</sup>	No <sup>2</sup>
501(e)	Cooperative Hospital Service Organizations	Performs cooperative services for hospitals	1023	990 <sup>1</sup> or 990-EZ <sup>8</sup>	Yes
501(f)	Cooperative Service Organizations of Operating Educational Organizations	Performs collective investment services for educational organizations	1023	990 <sup>1</sup> or 990-EZ <sup>8</sup>	Yes
501(j)	Certain Amateur Sports Organizations	Fosters national or international amateur sports competitions		990 <sup>1</sup> or 990-EZ <sup>8</sup>	
501(k)	Child Care Organization	Provides care for children	1023	990 or 990-EZ <sup>8</sup>	Yes
501(n)	Charitable Risk Pools	Pools certain insurance risks of 501(c)(3) organizations	1023	990 <sup>1</sup> or 990-EZ <sup>8</sup>	Yes
501(q)	Credit Counseling Organizations	Credit counseling services	1023	990 <sup>1</sup> or 990-EZ <sup>8</sup>	No

501(r)	Additional Requirement for Hospitals to Retain 501(c)(3) Status	Community health needs assessment, financial assistance, no extraordinary collection actions	N/A	N/A	N/A
521(a)	Farmers' Cooperative Associations	Cooperative marketing and purchasing for agricultural producers	1028	990-C	No
527	Political Organizations	A party, committee, fund, association, etc., that directly or indirectly accepts contributions or makes expenditures for political campaigns	8871	1120-POL <sup>10</sup> 990 or 990-EZ <sup>8</sup>	No

<sup>1</sup>For exceptions to the filing requirement, see Chapter 2 and the Form instructions.  
<sup>2</sup>An organization exempt under a subsection of §501 other than (c)(3) may establish a charitable fund, contributions to which are deductible. Such a fund must itself meet the requirements of §501(c)(3) and the related notice requirements of §508(a).  
<sup>3</sup>Contributions to volunteer fire companies and similar organizations are deductible, but only if made for exclusively public purposes.  
<sup>4</sup>Deductible as a business expense to the extent allowed by Code § 192.  
<sup>5</sup>Deductible as a business expense to the extent allowed by Code § 194A.  
<sup>6</sup>Application is by letter to the address shown on Form 8718. A copy of the organizing document should be attached and the letter should be signed by an officer.  
<sup>7</sup>Contributions to these organizations are deductible only if 90 percent or more of the organization's members are war veterans.  
<sup>8</sup>For limits on the use of Form 990-EZ, see Chapter 2 and the general instructions for Form 990EZ (or Form 990).  
<sup>9</sup>Although the organization files a partnership return, all distributions are deemed dividends. The members are not entitled to "pass-through" treatment of the organization's income or expenses.  
<sup>10</sup>Form 1120-POL is required only if the organization has taxable income as defined in IRC §527(c).

Chapter 18 also outlines the annual compliance requirements: filing one of the Forms 990, reporting back to the IRS when changes occur, and handling an IRS examination.<sup>4</sup> Chapter 19 contains annual tax compliance checklists for both charitable and noncharitable organizations. These lists are designed to be used by nonprofit managers and advisors each year to verify ongoing qualification for exempt status and satisfaction of the various filing requirements. Chapters 20 through 26 cover special issues that face a tax-exempt organization during its life—transactions with insiders, taxation of unrelated business income, relationships with other organizations and businesses, lobbying and electioneering, payroll taxes, mergers, and bankruptcy.

This introductory chapter presents the issues to consider prior to establishing an exempt organization, along with checklists to serve as a guide. An enlightening and thorough legal treatise on exempt organizations, written by the senior editor of the John Wiley & Sons Nonprofit Law, Finance, and Management Series, is *The Law of Tax-Exempt Organizations*, by Bruce R. Hopkins, now in its tenth edition. It is an extremely valuable resource for in-depth historical context and explanation.

Throughout the book, and particularly in the next few chapters, readers will note revenue rulings issued mostly in the 1960s and 1970s. These citations still reflect the precedential IRS view on the particular issue involved. Their age reflects an IRS policy, started in the late 1970s due to staffing limitations, to issue private letter rulings that eventually led to very few published rulings since the 1980s. Throughout the text, in the interest of indicating IRS current opinions on the topics, the private ruling, announcements, and information letter citations are provided.

## 1.1 Differences between Exempt and Nonexempt Organizations

An exempt organization is distinguished from a nonexempt organization by its ownership structure, the motivation or purpose for its operations, its activities, and the sources of revenue with which it finances its operations. Exempts are commonly called nonprofit or not-for-profit organizations under state law, which leads to a certain amount of confusion. The term *nonprofit* is a contradiction in one respect. To grow and be financially successful, an exempt can and often must generate revenue in excess of expenses, often called profits. It is perfectly acceptable for an exempt to accumulate funds as working capital, a building fund, or an endowment. Some also pay income tax on unrelated business income they are permitted to generate, as a modest part of their activity, to raise funding. Exempts are fascinating because they are full of such paradoxes and surprises.

Businesses do not often give away food or house the poor, but they do operate schools, hospitals, theaters, galleries, publishing companies, and other activities that are also carried on by exempt organizations. The nature of the activity or business is often the same for both. One goal of this book is to provide the tools for understanding why this duality exists and to provide guidelines for making the distinction between an exempt and a nonexempt organization.

<sup>4</sup> Considered extensively in J. Blazek and A. Adams, *Revised Form 990 Preparation Guide for Nonprofits* (Hoboken, NJ: Wiley Nonprofit Series, 2009).



The requirements for nonprofit status vary from state to state, and few generalizations apply. Exempt charitable institutions are called *public benefit* corporations in some states. Business leagues and social clubs are sometimes called *mutual benefit* corporations. Rather than being organized to generate profits for owners or investors, exempt organizations instead generate resources to accomplish the purposes of their broadly based public or membership constituents.

### (a) Choosing a Category

Do not expect the distinctions among the categories to be clear or logical. The group of exempt organizations has expanded considerably since the Tariff Act of 1894 established a single category of exempt organizations, which included charitable, religious, educational, fraternal, and certain building and loan, savings, and insurance organizations. Since then, the number of categories has expanded to include over 30 distinct types.

As with many federal tax matters, the Internal Revenue Code expresses general concepts subject to endless interpretation. Tax rules are often gray, rather than black and white, and require careful study to reach the desired result. For example, only scholars of legislative history can explain why agricultural organizations and labor unions are coupled together. Why aren't agricultural groups considered business leagues? Why are agricultural auxiliaries classified as business leagues? Why was a separate category carved out for real estate title-holding companies with multiple parents, instead of placing them in the original §501(c)(2) for single-parent organizations?

The choice of category is driven by a number of different factors that are presented in Chapters 2 through 10 along with cited examples of those that do qualify for exemption compared to those that do not. Often the choice is influenced by the desire to receive tax-deductible revenues. To receive a charitable donation, a §501(c)(3) charitable or (c)(19) veterans' group classification is required. However, the freedom to lobby is constrained by the (c)(3) category, so that the §501(c)(4) structure might be chosen instead by a charitable project that can be accomplished only through the passage of legislation, as discussed in Chapters 6 and 23.

### (b) Businesslike Behavior

Ironically, in order to be financially successful, a nonprofit can operate in a businesslike fashion—efficiently and often profitably. Most of the financial management tools applied by for-profit businesses—strategic planning, investment management, responsive organizational structure, budgeting, and others—are appropriately used by an exempt. A thorough consideration of this subject can be found in my book, *Nonprofit Financial Planning Made Easy*.<sup>5</sup>

The distinguishing characteristic of an exempt organization in this regard is the motivation for undertaking an activity that generates revenue. The fact that a nonprofit charges for the services it performs is not determinative. A school, a hospital, or any other type of exempt organization may pay all of its costs with fees paid by

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<sup>5</sup>John Wiley & Sons, 2008, 234 pages.

students, patients, and others using its facilities and services. Whether a hospital is exempt, for example, depends on whether it was created and operated to provide health care for the purpose of promoting the general public's health (see Chapter 4), not necessarily on whether it has a deficiency of patient revenues in comparison to its expenditures.

An exempt organization can generate revenues in excess of its expenses and accumulate a reasonable amount of working capital or fund balances. It can save money to purchase a building, to expand operations, to protect itself with a reserve for lost or reduced funding, to ensure a flow of cash to pay for continuous operations, or for any other valid reason serving its underlying exempt purposes. Many private foundations are endowed with assets that are as much as 20 times their annual expenditures since they are required to spend only 5 percent of the value of their investment assets each year.<sup>6</sup> There is no specific tax limitation on the amount of assets other types of exempt organizations can accumulate so long as the amount does not evidence a lack of exempt purpose.<sup>7</sup> Too high a level of expendable funds in relation to expenditures, however, can hamper an organization's fund-raising efforts. Public charities, business leagues, clubs, and other membership organizations that depend on annual support commonly have modest asset levels in relation to their annual spending. The level of accumulated assets may also influence funders that are sometimes reluctant to make grants to an exempt with significant reserve funds.

An exempt organization can also seek to borrow money from private or public lenders to finance its activities—to establish a new office or acquire an asset, for example. Basically, an exempt can operate without a profit motive and still produce a profit! It can pay salaries and employee benefits comparable to those of a non-exempt business. So long as the overall compensation is reasonable,<sup>8</sup> an exempt entity can offer incentive compensation to its employees. What it normally cannot do with its net profit is distribute it as a return on capital to the persons who control the organization or other private individuals.

The focus and purpose of an exempt organization's activity are outward and unselfish, and are directed at accomplishing a public purpose. One way to think of this characteristic is as a one-way street. Much of the money received by an exempt is one-way money—donations or dues paid out of pure generosity with nothing being received or expected in return. Nonprofits also operate on a two-way street regarding selling goods and services that accomplish their exempt purpose. Such revenue activity cannot be conducted strictly with the intention of producing a return on investment. In contrast, privately owned businesses operate totally on a two-way street. Their activity is directed at selling goods and services for the purpose of reaping return for their owners' investment.

On a limited basis, an exempt is allowed to compete directly with nonexempt businesses and operate a business that does not advance exempt purposes. The Internal Revenue Code places such an exempt on the same footing as competing businesses by imposing a regular income tax on profits from such activity. If the

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<sup>6</sup> See Chapter 15.

<sup>7</sup> See §2.2.

<sup>8</sup> See Chapter 20.

unrelated business activity becomes too substantial, the exempt can lose its exemption. Chapter 21 considers the question of when a business activity is unrelated, describes the level of business activity allowed, and presents the myriad exceptions and modifications that allow much of this type of income to escape taxation.

## 1.2 Nomenclature

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The complexity of this subject is illustrated by the fact that the Internal Revenue Code does not contain the word *nonprofit*—it refers only to exempt organizations. The term *nonprofit*, or *not-for-profit*, describes the type of organization created in most states and is widely used to identify tax-exempt organizations. The terms are often used interchangeably, as they are in this book.

Another factor coloring the distinctions is the language of the code. Tax rules are gray and not necessarily made clear by IRS rulings and decisions. In many cases, the terms used do not necessarily possess their dictionary definitions. To obtain exempt status, an organization applies for a determination by the Exempt Organization branch of the IRS. Form 1023 or 1024 is submitted to allow the IRS to determine whether exempt status is appropriate. A new entity seeking §501(c)(3) qualification will be classified as either a public or private charity based on the information provided. Ongoing classification will depend on data reported on Form 990. The former advance ruling system requiring the organization to report back to the IRS at the end of the first five years no longer exists; annual Form 990, Schedule A data serves to monitor qualification.<sup>9</sup> An exempt organization qualified under §501(c)(3) must be organized exclusively for exempt purposes within the specific terms described in the code and must operate primarily for such purposes.<sup>10</sup> The primary test is applied by deciding whether substantially all of the activity is exempt. Except for private foundations, “exclusively” does not mean 100 percent, and “primarily” can mean a little more than 50 percent. The facts and circumstances are examined in each case to ascertain qualification. Announcement of IRS exemption revocations in recent years cite lack of adequate records to prove ongoing qualification as the reason. The regulations provide a few specific numerical tests, which are indicated in the checklists when applicable. A numerical test is most often applied to gross revenues, but it can also be applied to net profits, direct costs, contributions, and the like. In each case, the IRS examines the exact facts to determine whether exemption is in order.

## 1.3 Ownership and Control

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Directors or trustees, as a general rule, may control and govern an exempt organization, but may not beneficially own it. Upon dissolution, a charitable exempt may not return any of its funds to its individual contributors or to controlling parties. Instead, its funds can be paid only to other charitable organizations or beneficiaries.

<sup>9</sup> Regs. §1.170A-9(f)(4)(v) for §509(a)(1) classification and §1.509(a)-3(d) for §509(a)(2) classification.

<sup>10</sup> See Chapter 2.

A business league, however, can rebate an accumulated surplus to its members upon dissolution, if the accumulation of such a reserve was not a primary purpose of the league. A mutual insurance company continually reduces premiums by the profits earned on investments.

The code of conduct for directors of exempt organizations is most often found in state law defining fiduciary responsibility and embodies the duties of care, loyalty, and obedience. Those who control an exempt are expected to manage the organization in the best interest of its exempt constituents, that is, its charitable class or membership, not to benefit themselves or their families. A common question concerning exempts is whether paid staff members can serve on the organization's board of directors. Such a dual position creates a conflict of interest. To evidence that the interests of the organization rather than the conflicted person are served, paid directors should not participate in votes approving their compensation or in other financial transactions that affect them. In Texas, a director or trustee may serve in a staff capacity for compensation so long as the pay is reasonable and not in violation of his or her fiduciary responsibility. However, other states limit the circumstances under which board members may serve as staff members. Funders sometimes impose restraints of this type. This question should be investigated under the laws of the state in which the exempt conducts its activities.

The federal tax code does not, as a general rule, prohibit the payment of compensation to private individuals, including board members and other organizational officials. IRC §501(c) does, however, for most types of exempt organizations, require that none of the profits or assets of an exempt organization inure to the benefit of private individuals. The meaning of the word *inure* is somewhat elusive and is primarily dependent on the reasonableness and necessity for payments to insiders. Private foundations are, as a general rule, prohibited from having any financial transactions with officials. The limited circumstances under which the rule is lifted for compensation for personal services and other payments to officials associated with the conduct of a foundation's programs are discussed in Chapter 14. In 1996, Congress subjected officials of public charities and civic welfare organizations to similar standards on the receipt of excessive compensation or other benefits called *intermediate sanctions*. The special rules that must be followed to document the appropriateness of insider payments are discussed in Chapter 20.

## 1.4 Role of the Internal Revenue Service

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The IRS giveth and taketh away an organization's tax-exempt status. Only §501(c)(3) organizations technically need IRS consent, called a *determination*, of their qualification. A (c)(3) organization is not classified as exempt until it makes its request for such status by filing Form 1023. For all other kinds of exempts, being established and operated according to the characteristics described in the tax code should be sufficient. However, most other categories of exempts have traditionally sought IRS determination to secure proof of their status for local authorities, members, and in some cases the IRS itself, and to ensure against penalties and interest due on their income if they do not qualify. To qualify for exemption from inception, a prospective §501(c)(3) organization must file a determination application within 27 months of its

creation. Later filing will result in a determination only from the date of filing, unless the IRS grants retroactive relief, which is unlikely. Careful timing in the formative stage is critical.

The Tax Exempt Organizations Division of the IRS began to reorganize itself in October 1999. The *blueprint* for the changes reflected an intention to be proactive in disseminating useful information to its exempt *customers*. Organizations are encouraged to direct their questions to a toll-free Tax Exempt Customer Service Representative line.<sup>11</sup> Personnel are trained not only to answer the specific questions asked but to get additional information. They offer to send publications and information about workshops and seminars on filing requirements, return preparation, and other subjects they identify the organization could benefit from knowing.

The IRS plan addressed the fact that “Exempt Organization customers represent a very diverse segment ranging from churches and small local clubs to large national organizations.” Beginning in 2007, all nonprofits recognized as tax-exempt, other than churches, are required to file one of four different types of Form 990.<sup>12</sup>

Due to reduced funding over the years, the IRS EO Division has significantly reduced its personnel and published guidance issued to construe the rules. Chapter 18 briefly outlines matters that bring an organization into contact with the IRS, such as changes in purpose, public status, and fiscal year and offers suggestions for successful communication with the IRS. Annual information return (Form 990, 990-PF, or 990-T) filing requirements are also outlined. These returns contain detailed financial information, lists of directors and officers and their compensation, and descriptions of activities. The returns must be made available to anyone that asks for a copy; for charitable organizations, the returns are posted on [www.guidestar.org](http://www.guidestar.org) as well as other Web sites. It is extremely important that they be prepared with care, such as with the aid of a publication that contains detailed line-by-line guidelines and filled-in forms.<sup>13</sup>

## 1.5 Suitability as an Exempt Organization

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Before embarking on the creation of a nonprofit organization to seek tax exemption, some basic questions that may influence the decision to go forward should be addressed. Although certain requirements are applied precisely according to published guidelines, the rules are often ambiguous and subject to varying interpretations. The IRS determination branch is skilled (except for new recruits) and the highest scrutiny applied by the IRS to exempt organizations often occurs when they review Forms 1023 or 1024. Though not expressed, the goal seems (and will probably continue) to be to weed out questionable organizations at their inception because the IRS has very limited resources for subsequent examinations. Until 2004, the form and its instructions did not reveal the import of the information requested. Applicants described their plans in some detail, with projected activities and

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<sup>11</sup> As of January 2004, the toll-free Taxpayer Assistance line is 1-877-829-5500.

<sup>12</sup> See Chapter 18.

<sup>13</sup> See Jody Blazek and Amanda Adams, *Revised Form 990 Preparation Guide for Nonprofits* (Hoboken, NJ: Wiley Nonprofit Series, 2009).

associated financial budgets, and it was up to the reviewer to interpret the worthiness of the plans.

Form 1023 was revised in 2004.<sup>14</sup> A cyber-assisted version is promised to streamline the process. Readers should be alert for changes in this evolving process. Professional assistance from accountants and lawyers familiar with nonprofit matters can be very useful in achieving approval. If funds are limited, a qualified volunteer can be sought. In many states, pro bono assistance is available through technical support centers staffed by volunteers from certified public accountant (CPA), bar, and other professional associations.

Before a prospective project is formally established, four major questions should be asked to determine whether a proposed organization is suitable for qualification for tax-exempt status and ongoing operation as a nonprofit project.

#### **(a) Question 1: Is a New Organization Really Necessary?**

Could the project be carried out under the auspices of an existing organization? Several factors can indicate that a new organization is not necessary. If the proposed project is a short-term or one-time objective with no prospect for ongoing funding, it may not be worth the trouble to set up an independent exempt to handle it. Maybe the project can operate as a branch of an existing exempt organization. If a local branch of an organization holding a group exemption is available through a national organization, the new exempt may be formed as a member of the group, thereby avoiding the need to seek separate qualification for tax exemption.<sup>15</sup> If there would be a costly duplication of administrative effort, or if the cost of obtaining and maintaining independent exemption would be excessive in relation to the total budget, it makes sense to opt for another route.

#### **(b) Question 2: Which Category of Exemption Is Appropriate?**

If the proposed organization passes the first test, the category of exemption best suited to the goals and purposes of the project must be chosen. Due to the rigidity and limitations of the §501(c)(3) exemption rules, certain activities may be suitable only for other categories of exemption. The (c)(3) rules include a complete prohibition against involvement in political campaigns and limitations on legislative and grassroots lobbying.<sup>16</sup> For such projects, a §501(c)(4) organization may be more suitable for the purposes of the founding group.

Some projects can conceivably qualify for more than one category. There are garden clubs classified as charities under §501(c)(3), civic welfare societies under §501(c)(4), and social clubs under §501(c)(7). An association of businesspersons, such as a professional association or the Lions Club, most often qualifies as a business league.<sup>17</sup> If the activities of the group involve educational and/or charitable efforts, (c)(3) status, rather than (c)(4)–(6) status, might be sought, or two

<sup>14</sup> See Blazek, *IRS Form 1023 Tax Preparation Guide*.

<sup>15</sup> See §18.1(f).

<sup>16</sup> See Chapter 23.

<sup>17</sup> See Chapters 6 through 9.

organizations—a (c)(3) and a (c)(6)—might be formed. A breakfast group composed of representatives of many different types of businesses may not qualify as a business league under §501(c)(6), but might instead easily qualify under §501(c)(7). The tax deductibility of member dues and taxability or limitation on types of income influence the desired choice of category.<sup>18</sup> The creation of a nonexempt nonprofit can also be considered. When profits are expected to be minimal, the projected federal, state, and local taxes due might be less than the cost of obtaining and maintaining tax exemption.

### (c) Question 3: Do Expected Revenue Sources Indicate Nonprofit Character?

Next, the proposed sources of revenues expected to support the project must be considered. Exempt organizations are traditionally supported by donations, member dues, and fees for performing exempt functions, such as admission to a museum or fees for certification of professional standing. Certain sources of revenue are not suitable for exemption. Among those sources are sales of goods produced by members (unless handicapped or underprivileged) and income from services rendered in competition with nonexempt businesses (for example, insurance or legal services). Too high a level of revenue from unrelated businesses can disqualify exemption.<sup>19</sup> Self-dealing and certain other insider transactions may be prohibited<sup>20</sup> and certain sources of support could result in the exempt organization being designated a private foundation subject to stringent operating requirements.<sup>21</sup>

### (d) Question 4: Are Creators Motivated by Selfish Goals?

A tax-exempt organization as a rule must be established to serve persons other than its creators (though creators can participate in its affairs). This question examines the reasons why persons seek to establish the nonprofit. Do the organization's creators desire economic benefits, other than savings resulting from tax deduction for donations from the formation or ongoing operation of the organization? Will the organization be operated to serve the self-interested purposes of its creators? If so, it is likely the project cannot qualify for tax-exempt status. The one-way-street characteristic of nonprofits is crucial to ongoing qualification for tax exemption. If the founders desire incentive compensation based on funds raised, or wish to gain from profits generated, an exempt organization may not be the appropriate form of organization. Reasonable compensation for services actually and genuinely rendered can be paid, but no private benefit to insiders or significant participants can result from the exempt's activities.<sup>22</sup>

For a variety of reasons, it is sometimes desirable to convert a for-profit business into a nonprofit one. In the health and human services field, for example, funding is often available from both for-profit and nonprofit sources. An organization's

<sup>18</sup> See Chapters 2 through 10 for rules applicable to various categories of exempt organizations.

<sup>19</sup> See Chapter 21.

<sup>20</sup> See Chapters 14 and 20.

<sup>21</sup> See Chapters 11–17.

<sup>22</sup> See Chapter 20.

direction may change or funds may become available only for tax-exempt organizations, such as for health issue research programs. When an exempt is created to take over the assets and operations of a for-profit entity, the buyout terms will be carefully scrutinized. Too high a price, ongoing payments having the appearance of dividends, and assumptions of liability that take the creators off the hook are among the issues faced in this situation.

When a tax-exempt organization ceases to exist, its assets to be distributed on dissolution must essentially be used for the same exempt purposes for which the organization was initially granted tax exemption. Charities exempt under §501(c)(3) can distribute funds only to another (c)(3) organization or in support of a charitable project, and their charters must contain a binding dissolution clause. Assets of a charitable tax-exempt organization must be permanently dedicated to charitable purposes. Again, the one-way-street concept exemplifies the character of a tax-exempt organization. The creators must understand and intend from inception that they will gain no personal economic benefit from the organization's operations and benefits. Exhibit 1.2 can be used to review the considerations in forming a new exempt organization.

## 1.6 Start-Up Tax and Financial Considerations

A project that meets the criteria in the previous section indicating that a new non-profit organization is suitable under the federal tax rules also has significant financial issues to consider before the nonprofit is formed. One important issue that must be thoroughly considered is organizational structure—whether to form a corporation versus a trust, how the board will be chosen, and what bylaw provisions are suitable, among others. Financial issues should be considered and quantified—projections prepared, feasibility studies conducted, and seed money sources identified. A business plan of the sort prepared by a for-profit organization to seek investment capital can be useful in the planning stage of a new nonprofit. Much of the information that is gathered for that purpose is the same as that required for completion of Form 1023 or 1024 to seek recognition of tax-exempt status. Operational plans should commence—financial management, record-keeping requirements, staffing, and other issues outlined in Exhibit 1.3.

### (a) Preliminary Planning

An important start-up question concerns the type of entity to be created. Founders must decide the type of organization that should be formed—corporation, trust, or association. Each structure has its benefits and drawbacks.<sup>23</sup>

Future sources of funds to operate the proposed nonprofit should next be projected in the planning stage for several reasons. First and foremost, creators should evaluate the financial feasibility of their ideas. It is laudable to want to feed the poor in one's county; the question to ask at this stage is whether the group forming the program can put together enough funds to efficiently do so. Second, many categories

<sup>23</sup> See §1.7.



**EXHIBIT 1.2 Suitability for Tax-Exempt Status Checklist**

*A predominance of "yes" answers to the following questions indicates the proposed organization is NOT a suitable candidate for tax-exempt status or that special rules may apply. Chapter sections cited can be studied for more discussion of each issue.*

	Yes	No
<b>1.</b> Is a new organization necessary, or could the project be carried out as a branch of an existing organization?		
Life of the project is short.	<input type="checkbox"/>	<input type="checkbox"/>
It is a one-time project with no prospect for ongoing funding.	<input type="checkbox"/>	<input type="checkbox"/>
Project could operate under auspices of another EO.	<input type="checkbox"/>	<input type="checkbox"/>
Duplication of administrative effort is too costly.	<input type="checkbox"/>	<input type="checkbox"/>
Cost of obtaining and maintaining independent exemption is excessive in relation to total budget [Ch. 18].	<input type="checkbox"/>	<input type="checkbox"/>
Group exemption is available through a national EO [Sec. 18.2(f)].	<input type="checkbox"/>	<input type="checkbox"/>
<b>2.</b> Which §501(c) category of exemption is appropriate to the goals and purposes of the project?		
The organization participates in efforts to influence elections or otherwise participate in political campaigns [Ch. 23].	<input type="checkbox"/>	<input type="checkbox"/>
Purposes of the organization can be accomplished only through legislative and grassroots lobbying activity [Ch. 6 and 23].	<input type="checkbox"/>	<input type="checkbox"/>
Activities benefit a group of businesspersons or a social group? [Ch. 7, 8, and 9].	<input type="checkbox"/>	<input type="checkbox"/>
Persons benefited by the proposed activities represent a limited group rather than a charitable class? [Sec. 2.2(a)].	<input type="checkbox"/>	<input type="checkbox"/>
<b>3.</b> Are the sources of revenue suitable for an exempt organization?		
Organization plans to sell goods produced by members indicating a cooperative [Sec. 2.2(e)].	<input type="checkbox"/>	<input type="checkbox"/>
A significant amount of the revenues will come from services to be rendered in competition with nonexempt businesses, such as legal services or insurance? [Sec. 21.8].	<input type="checkbox"/>	<input type="checkbox"/>
Over half of revenues will be from unrelated businesses operated in competition with for-profit companies? [Sec. 21.4(b)].	<input type="checkbox"/>	<input type="checkbox"/>
A majority of the funding will come from a particular individual, family, or limited group of people that may require classification as a private foundation [Ch. 11–17].	<input type="checkbox"/>	<input type="checkbox"/>
<b>4.</b> Do the creators desire economic benefits from the operation of the organization?		
Transactions with related parties are anticipated [Sec. 20.1].	<input type="checkbox"/>	<input type="checkbox"/>
Proposed financial arrangements with creators will pay portion of revenues to insiders as rent, royalty, or interest [Sec. 20.6].	<input type="checkbox"/>	<input type="checkbox"/>
Creators wish to be paid incentive compensation based on funds raised or profitability of the organization [Sec. 2.1(c) and 20.2(c)].	<input type="checkbox"/>	<input type="checkbox"/>
Assets will be purchased and/or debts of creators assumed [Sec. 20.6].	<input type="checkbox"/>	<input type="checkbox"/>
Project will operate in partnership with for-profit investors [Ch. 22].	<input type="checkbox"/>	<input type="checkbox"/>
Services and activities will be available to a limited group of persons or members instead of a public class? [Sec. 2.2(a) and 8.2].	<input type="checkbox"/>	<input type="checkbox"/>
Upon dissolution of the organization, assets can be returned to creators and/or major donors [Sec. 2.1(b)].	<input type="checkbox"/>	<input type="checkbox"/>

**EXHIBIT 1.3 Basic Tax and Financial Considerations in Starting a New Nonprofit Organization****ORGANIZATIONAL ISSUES:**

- Suitability for exempt organization status [See Exhibit 1.2.]
- Form of organization/corporation, trust, or association [Sec. 1.7]
- Organizational documents
  - Mission statement/purpose clause [Sec. 2.1]
  - Membership or not
  - Provisions of bylaws
  - Board composition and terms for advisors
- Choose name and check availability
- Federal tax considerations
  - Qualification for tax exemptions [Ch. 2–10]
  - Amount of business activity planned [Ch. 21]
  - Transactions with creators, directors, and officers [Ch. 14 and 20]
  - Private vs. public charity [Ch. 11]

**FINANCIAL CONSIDERATIONS:**

- Capitalization needs
  - Future need for capital and ability to raise funds
  - Reliability of funding sources
- Financial planning systems
  - Long- and short-range financial plans (budgets)
  - Maximizing cash flow and investment income
  - Billing, collection, and bill-paying policies
- Internal control systems

**RECORDKEEPING SYSTEMS:**

- Primary accounting records (banking records, original invoices, and customer/patron/client billings)
- Secondary records (cash, general, payroll, and other ledgers)
- Cash vs. accrual method
- Cost accounting systems
- Fund accounting and donor/member database software
- Filing systems
  - Paid bills in alphabetical order
  - Permanent assets (individual files by objects or type)
  - Establish “throwaway” date system
  - Exempt activity records (archives)
- Tax compliance systems [Ch. 19]
  - Application for federal identification number and exemption
  - Complete federal tax compliance checklist
  - State and local registration, permits, and/or taxes
- Employees vs. independent contractors [Ch. 25]
  - Tax aspects: proper classification, withholding, and reporting requirements
  - Personnel policies: vacation, sick leave, written contracts, and job descriptions
  - Fringe benefits
  - Travel and expense documentation requirements

of exempt organization have special attributes and standards measured by their sources of funding for reasons explained in the chapter pertaining to that particular type of organization. If the exempt organization wishes to be classified as a charity, for example, it is time to see whether the organization will qualify as a public charity or a private foundation. Expected donation levels must be quantified to measure public support.<sup>24</sup> Social clubs are subject to strict numerical limits on the amount of non-member revenues they may receive.<sup>25</sup> Business leagues and labor unions, like charities, cannot generate an amount of unrelated business income that indicates the business activity is their primary function. The specific plans for the proposed organization should be tested at this point from a financial standpoint, using the basic rules for qualifying as a tax-exempt organization.<sup>26</sup>

Whether the organization will operate as a membership group must be decided. The term *membership* is often misunderstood and misused. Some organizations use the term *member* to designate contributors who actually have no voting rights. Under some state governance standards, a membership organization is one whose members elect the persons on the governing board. The democracy afforded by such a form of organization may or may not be desirable. A self-perpetuating board retaining control in the hands of a few persons may be appropriate, indicating that a non-membership organization should be formed.

The rules governing the organization's future decision-making procedures are outlined in the bylaws. The answers to the following questions, among many others, are found in the bylaws: How will officers be elected? When will meetings be held, and who can call them? Who will serve as advisors? Who signs checks? What credentials will be required of board members, and what length of term will they serve? A skilled attorney can be very helpful in designing appropriate bylaws. The IRS and some states are not particularly interested in parliamentary procedures. No sample bylaws are provided in IRS Publication 557, *Tax-Exempt Status for Your Organization*. On the other hand, this guide prescribes very particular provisions that must be contained in an organization's articles of organization for exemption to be granted. For groups affiliated with a state or national group, model articles and bylaws may be available.

This is a good time to think about what name to bestow on the organization. A name that accurately presents the organization's purpose should be chosen. The words *fund* or *foundation* might not be suitable in a name for a nonprofit that intends to do fund-raising for operating support because the words connote that it already has resources. Similarly, the word *center* connotes a place where people gather for a variety of reasons, and *institute*, a place where people meet to talk and study. The name cannot repeat or conflict with names already in use. If there is already a Center for Genetic Research chartered in the state, a newly created Center for Genetic Study may not be permitted. The availability of the chosen name can be investigated through the local and state authorities. In Texas, the office of the secretary of state can be called to check availability and to reserve a name.

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<sup>24</sup> See Chapter 11.

<sup>25</sup> See Chapter 9.

<sup>26</sup> See Chapter 8.

### (b) Financial Management

In a nutshell, to be successful a nonprofit organization should be financially managed just like a business. To be financially viable, an exempt organization needs sufficient capitalization similar to a for-profit organization—but it cannot float a stock issue. The reliability of funding sources should be evaluated to ensure sustainable spending levels. Before the final decision to establish a new organization is made, the exempt's future needs for capital and its ability to raise money must be projected.

The initial projections can be a starting point for an ongoing planning process that can improve the financial well-being for an exempt organization. Short-range budgets and long-range financial plans should be maintained and continually updated. Operating and capital budgets are recommended. Plans for maximizing yield on cash and other investment assets should be formulated. As much of the exempt organization's money as possible should be kept in interest-bearing accounts, and professional investment managers can be sought once capital reserves exceed immediate needs.

An accounting system and procedure should be established to record, report, and internally control the financial resources in accordance with generally accepted accounting principles. This system should also maximize cash flow by billing customers and collecting from contributors as quickly as possible while at the same time delaying payment of the organization's own bills for as long as is reasonable. Guidance on this vitally important aspect of the operation of a nonprofit organization can be found in the book *Nonprofit Financial Planning Made Easy*.<sup>27</sup>

## 1.7 Choosing the Best Form of Organization

The three common structural forms for a nonprofit organization are nonprofit corporation, trust, or unincorporated association. The choice of organizational form is influenced by the laws of the states in which the nonprofit will operate. Certain categories of §501 organizations are limited in their choice of form. A title-holding company, for example, must be a corporation. Some §501 categories of exemption apply to clubs, associations, leagues, and posts, and may have unique organizational structures. An experienced attorney knowledgeable about nonprofit organizations can be extremely valuable in making this choice. If the project needs to seek volunteer or pro bono assistance due to limited funds, the local bar association or accountants' society may have such a program.

Whichever form of organization is chosen, the federal tax code and regulations often have differing requirements from those of the state in which the nonprofit is established. Particularly for those seeking classification as §501(c)(3) organizations, the standards for federal exemption are very specific and commonly more stringent than those of the state. A charter that allows a nonprofit to conduct those activities permitted under local law may not necessarily qualify for federal exemption. Caution must be used in drafting a charter.<sup>28</sup>

<sup>27</sup> John Wiley & Sons, 2008, 234 pages.

<sup>28</sup> See Chapter 2.

### (a) Corporation

Corporate status is said to be the most flexible form of organization for a nonprofit and is the form of choice in most states. Some nonprofit assistance programs established by local united giving organizations and volunteer lawyer and accountant associations have developed model organizational documents that an organization can use in designing its corporate charter.

Creating a corporation as a separate entity is said to establish a corporate veil that may shield the individuals governing and operating the nonprofit from liabilities incurred by the organization, unless they are negligent or somehow remiss in their duties. Some states have adopted immunity laws augmenting protection against liability for directors and officers of nonprofits. In Texas, the Charitable Immunity and Liability Act of 1987 applies to §501(c)(3) organizations. This statute shields a charity's officers, directors, and volunteers, regardless of the form of organization, thus obviating one of the advantages in establishing a corporation. These rules are different for the particular state(s) in which the nonprofit operates and should be carefully studied.

Though historically many nonprofit organizations had members, an exempt corporation can be formed with or without members. Unless the charter provides otherwise, members are presumed in some states. The primary role of members in this context is to elect the board of directors, who in turn govern the organization. In a privately funded organization, the members may be family representatives whose job is to retain control. The founder of a charity can be named the only member. With most public benefit corporations, members broaden the base of financial support and involve the community in the organization's activities. In such cases, there may be hundreds or thousands of individual contributors who, as a group, control the organization because they elect the directors. Mutual benefit societies, unions, clubs, and the like are usually controlled by their dues-paying members.

The other choice is to allow the board of directors to govern the organization. Closer control can be maintained by a small, self-perpetuating board that chooses its own successors. The charter may also appoint representatives of specified organizations or institutions to occupy board positions. A city arts council board might automatically have a representative of the city museum, the college art department, and the symphony orchestra, as well as an individual artist, alongside those directors elected by members. A charity seeking classification as a supporting organization must very carefully design its governing structure to satisfy one of the tests found in IRC §509(a)(3).<sup>29</sup>

Bylaws are adopted by a nonprofit corporation to provide rules of governance, such as the number of directors, duration of director terms, and procedures for removing them. Bylaws typically also address the frequency of meetings, notice procedures, type and duties of officers, delegation of authority to committees, and the extent of member responsibility. The manner in which the bylaws can be amended should also be covered in the bylaws. Indemnity to directors may be provided.

An advantage of the corporate form, as compared to a trust, is that its organizational documents can often be easily amended. Usually, the currently serving board

<sup>29</sup> See §11.6.

has authority to make changes to both the bylaws and the charter. Though such changes may require approval and must be submitted to both the state and the IRS, they are allowed and do not customarily impact tax-exempt status. A nonprofit corporation's articles can (and normally do) allow its directors and members to mold and change its provisions as the organization evolves throughout its existence.

### (b) Trust

The trust form of organization is often chosen for an individually or family-funded charitable organization. A trust created while one is living is called an *inter vivos* ("among the living") trust. A trust created by a bequest in the creator(s)' will is called a *testamentary* trust. A trust is favored by some because, unlike a corporation, a trust can be totally inflexible absent a reformation approved by a court order. A trust can be created without provisions allowing for changes in its purpose or trustees. Thus, a donor with specific wishes may prefer this potentially unalterable form for a substantial testamentary bequest. Another advantage of a trust is that some states require no registration of a charitable trust. Finally, a wholly charitable trust described in §4947 (a)(1) is not necessarily required to seek recognition of its tax-exempt status although many do so to aid in fund-raising.

There is sometimes an argument that a charitable trust violates the rule against perpetuities. To get around this potential obstacle, a trust instrument might contain a provision allowing the trustee(s) to convert the trust into an exempt corporation with identical purposes and organizational restraints. Conversion to a nonprofit corporation might also be allowed if the trustees find that the trust form is disadvantageous. Exempt organization immunity statutes do not apply to trusts in some states, and more stringent fiduciary standards are often imposed upon trustees than on corporate directors. As a rule, trustees are said to be more exposed to potential liability for their actions than are corporate directors. The tax rates on unrelated business income of a trust are higher than the rate applied to corporations though the charitable deduction allowed for contributions made by a trust to other organizations is 50 percent of its taxable income rather than 10 percent.

### (c) Unincorporated Association

The unincorporated association form of nonprofit organization is the easiest to establish and, correspondingly, to reform. To qualify for exemption, an association must have organizing instruments outlining the same basic information found in a corporate charter or trust instrument. Rules of governance must be provided and it must have regularly chosen officers. Particularly for §501(c)(3) status, the IRS requires specific provisions in the documents prohibiting certain activities.<sup>30</sup> IRS procedures require that the constitution or articles of association must be signed by at least two persons.<sup>31</sup> There are few established statutes or guidelines to follow.

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<sup>30</sup> See §2.1.

<sup>31</sup> Instructions for Form 1023 issued in 2006, page 7.

National and statewide organizations and nonprofits with branches or chapters can facilitate orderly governance for their subordinates by furnishing a uniform structure document.

An unincorporated group may face substantial pitfalls. The primary concern is lack of protection from legal liability for officers and directors. Banks and creditors may be reluctant to establish business relationships without personal guarantees by the officers or directors.

#### **(d) Limited Liability Companies**

A tax-exempt organization might form a single-member limited liability company (LLC) for purposes of isolating itself from the liability associated with conducting certain activities. The check-the-box rules allow the single member to disregard such an entity as separate from itself and treat the activities of the LLC as part of the parent organization. The financial activities of the LLC can be reported on the parent's own Form 990(s) rather than on a separate return. An LLC electing to be treated as a separate organization is not mentioned, but presumably would file its own return.

An LLC electing to be treated as a separate organization can seek tax exemption under §501(c)(3) if its member(s) are §501(c)(3) organizations.<sup>32</sup>

Several states have adopted a new form of hybrid for-profit/nonprofit organization called an *L3C*, ("low-profit limited liability company") designed to allow combined ownership by private investors and nonprofits. The primary purpose of the *L3C* must be to accomplish one or more charitable purposes. The investment by a nonprofit essentially takes the form of a program-related investment (PRI) allowed for private foundations.<sup>33</sup> The IRS (as of October 2011) has not issued guidance with respect to *L3Cs* due to the ambiguities with respect to *L3Cs* and the federal tax law.<sup>34</sup> Some advisors to tax-exempt organizations are of the opinion that an investment in an *L3C* can qualify as a charitable expenditure following the well-established PRI rules that involve LLCs and other for-profit companies.

#### **(e) Conclusion**

Once a decision has been made that a tax-exempt entity is suitable, the form of organization is chosen, and the necessary organizational requirements satisfied, the specific category of exemption can be chosen. Exhibit 1.1 lists the more than 30 types of organizations included in the Internal Revenue Code. Chapters 2 through 10 discuss the particulars of the first seven types. Exhibit 1.4 compares the filing requirements and primary characteristics of categories (c)(2) through (c)(7). Chapters 11 through 17 consider the important distinction between public and private charities and

<sup>32</sup> According to Instructions for Form 1023 (Rev. June 2006), which is submitted for entities seeking §501(c)(3) status. See §2.2(g) for IRS organizational issues.

<sup>33</sup> See §16.3.

<sup>34</sup> Remarks of Ronald Schultz, senior technical advisor in the IRS Tax Exempt/Government Entities Division on June 11, 2009, at the AICPA Nonprofit Industry Conference.

**EXHIBIT 1.4 Comparison of Requirements and Tax Attributes for IRC §§501(c)(2), (3), (4), (5), (6), and (7)**

	(c)(2)	(c)(3)	(c)(4)	(c)(5)	(c)(6)	(c)(7)
Exemption application required.	Y	Y	N	N	N	N
Time limit for filing IRS application for exemption (27 months).	N	Y	N	N	N	N
Form 1023 filed.	N	Y	N	N	N	N
Form 1024 filed.	Y	N	Y	Y	Y	Y
<b>REGARDING CHARTER/INSTRUMENT:</b>						
Purpose clause limiting.	Y	Y	N	N	N	N
Dissolution clause required.	N	Y	N	N	N	N
Activity limitations required.	Y	Y	N	N	N	N
<b>REGARDING PAYMENTS TO EO:</b>						
Receive tax deductible contributions.	N	Y	N	N	N	N
Receive tax deductible business dues.	N	N	N/Y	Y/N	Y/N	Y/N
<b>REGARDING REVENUES:</b>						
Annual support test for private foundation class.	N	Y	N	N	N	N
Membership primary income source.	N	N/Y	Y/N	Y	Y	Y
Amount of nonmember income limited.	N	N	N	N	N	Y
<b>REGARDING UBIT:*</b>						
Investment income exempt from UBIT unless investment indebted.	Y	Y	Y	Y	Y	N
Volunteer and donated property exceptions available for UBIT.	Y	Y	Y	Y	Y	Y
Convenience exception.	N	Y	N	N	N	N
Amount of UBI <sup>†</sup> must be limited.	N	Y	Y	N	N	Y
<b>REGARDING ACTIVITIES:</b>						
Can engage in political campaigns.	N	N	N/Y	Y	Y	Y
Can engage in lobbying.	N	N/Y	Y	Y	Y	Y
Lobbying activity limited.	Y	Y	N	N	N	N
Broad purposes can be pursued.	N	Y	Y	N	N	N
Private inurement/benefit prohibited.	Y	Y	Y	Y	Y	Y
Operations must primarily be exempt.	Y	Y	Y	Y	Y	Y
Can carry out active projects.	N	Y	Y	Y	Y	Y

\*Unrelated business income tax.

<sup>†</sup>Unrelated business income.

thoroughly present the special rules applicable to private foundations. Chapters 18 and 19 contain guidance about IRS filing and tax compliance issues, including comprehensive annual checklists. Chapters 20 through 26 address compliance issues in depth—private inurement, unrelated business income, lobbying and political campaign activities, donor tax deductibility, employment taxes, and transformations such as mergers and bankruptcies.