# Self-Help Application Guide: 501(c)(3) Charitable Exemption

#### INTRODUCTION:

- Section 501(c)(3) of the IRS Code grants tax exempt status to organizations that are "charitable", "educational", and "religious". This self-help guide is geared primarily towards "charitable" organizations but may also be helpful for others as well.
- Every corporation, even a nonprofit, must file a corporate income tax return UNLESS it has been granted an exemption by the IRS. <u>There are twenty-two different types of</u> <u>exemptions</u> listed in Section 501 of the IRS Code. Besides the "(c)(3)" exemption the other types include those for civic leagues, social welfare organizations, labor unions, business leagues, social clubs, farmer's coops, etc.

# ADVANTAGE OF 501(c)(3) EXEMPTION

- Contributions to a 501(c)(3) entity are tax deductible for the donor
- Only 501(c)(3) organizations qualify for foundation grants.

### QUICK OVERVIEW OF THE QUALIFICATION PROCESS

• To obtain tax exempt status from the IRS you must first create a corporation by filing the appropriate paperwork with your state government (<u>CLICK HERE</u> to download a collection of forms to create a Florida nonprofit corporation suitable for federal tax exemption). Then, you must apply to the IRS for the exemption. This document will not tell you how to answer every question on the application. The IRS has an excellent instruction booklet that you can download (see below). Instead, this article provides background information, suggestions, and tips to help you better understand the issues so that you can avoid mistakes that can delay the approval of your application by the IRS.

# THE NECESSARY APPLICATION FORMS

- Form 1023: Application for Exempt Status
- Form 1023 Instructions
- CLICK HERE to go the IRS download page for tax forms
- IRS Publication 557 (on-line) Exempt Status for Your Organization

# QUALIFICATION TO BE A 501(C)(3) ORGANIZATION

- WORKING DEFINITION: a 501(c)(3) entity is a corporation that is "organized and operated" exclusively for charitable, educational, or religious purposes, no substantial part of whose activities involve trying to influence legislation, does not endorse political candidates, and does not operate for the "private benefit" of insiders (members, founders, directors, etc.) or some other small group of people (though it can pay reasonable compensation for services actually performed).
- Click Here to view the federal regulations governing 501(c)(3) organizations.

Now, let's break this down and look at each part of the definition.

- ORGANIZATIONAL TEST: the corporation must be "organized" exclusively for charitable purposes. To meet this test specific language must be included in the articles of incorporation stating that [1] the organization is organized and operated exclusively for an exemppt purpose and [2] if it dissolves, the organization's assets are to be transferred to another 501(c)(3)organization. See IRS Publication 557 for a further discussion. The proper wording for these provisions is contained in the documents that can be downloaded using the links in the following two subsections
  - <u>CLICK HERE</u> to download a "zip" file containing a complete set forms (with instructions) for creating a new Florida nonprofit corporation with Articles of Incorporation that meet organizational test.
  - <u>CLICK HERE</u> to download a template for "Articles of Amendment" (to amend the Articles of Incorporation of an existing Florida corporation so that it meets the "organizational test")
- **OPERATIONAL TEST**: To be considered "charitable" the organization must "operate" "exclusively" for charitable purposes. Whether or not you initially meet this test depends on what you tell the IRS in the "narrative" portion of of the application (IRS Form 1023). See below. The following are recognized by the IRS as charitable purposes:
  - relief of the poor and distressed or of the underprivileged
  - advancement of religion
  - advancement of education or science
  - erection or maintenance of public buildings, monuments, or works
  - lessening of the burdens of Government
  - lessening neighborhood tensions
  - elimination prejudice and discrimination
  - defending human and civil rights secured by law
  - combating community deterioration
  - combating juvenile delinquency

Note that "lessening burdens of government" and "combating community deterioration" are general catch-alls which can cover many nontraditional charitable activities. Therefore, a careful description in the narrative section of your application is needed of the "charitable purposes" to be achieved

- NO EXCESSIVE PRIVATE BENEFIT. An organization is not organized or operated exclusively for one these purposes unless it serves a public rather than a private interest. an organization must establish that it is not organized or operated for the benefit of private interests such as designated individuals, the founder or his family, members of the organization, or persons controlled, directly or indirectly, by such private interests. Your members and directors are allowed to benefit but only as part of the larger community but not as a privilege inherent in their insider status. If the IRS determines that the main purpose is to bring private benefit the exemption may be denied by the IRS.
- "EXCLUSIVELY" vs "SUBSTANTIALLY". To be exempt the organization must be
  "exclusively" charitable (etc.). You would think it means that an organization can't do
  anything but conduct charitable activities. However, the IRS and the courts have interpreted
  "exclusively" to mean "substantially". That is, an organization can carry on "incidental" non
  charitable activities. For example, a charitable organization can conduct some business
  activities that are unrelated to its charitable purposes without losing its tax exempt status

[see the discussion of "unrelated trade or business" below]. Remember, however, that the IRS will look closely at organizations that operate in a manner that makes charity appear to be only a secondary purpose.

# TWO TYPES OF 501(C)(3) ORGANIZATIONS: PUBLIC CHARITY VS PRIVATE FOUNDATION.

- In granting 501(c)(3) status the IRS will classify the organization as being either a "public charity" or "private foundation". A private foundation is a 501(c)(3) entity that does not qualify as a public charity. The choice is made by the IRS and not the organization. The classification is based on the sources of the organization's support.
- PUBLIC CHARITY (technically: "Publicly Supported Organization") is a 501(c)(3) organization that meets the 1/3 public support test, that is, it receives at least one third of its support from "public" sources such as small contributions, government grants, or from other public charities AND it does not receive too much income from investments. If an organization qualifies it will not be subject to the restrictions applicable to private foundations. For example, The Ford Foundation is a "private foundation" because it does not get any support from the general public or the government and it is not affiliated with or controlled by another organization which itself gets public support. In contrast, your local United Way is a "public charity" because it receives broad public support. Also, an organization that depends on government grants will likely be classified by the IRS as a "public charity" because government grants are considered a public support.
  - ADVANTAGES OF BEING A "PUBLIC CHARITY":
    - Private foundations have more restrictions on their activities
    - The rules governing the deductibility of contributions are more favorable.
    - For public charities there is no tax on its investment income [if it has any], while a private foundation must pay a 2% tax
  - The IRS considers certain organizations to be public charities simply by the nature of their activities (schools, hospitals, religious organizations, etc.) or because the organization is affiliated with or controlled by another public charity.
  - For most 501(c)(3) organizations, however, the IRS presumes that it will be a private foundation UNLESS that organization can overcome the presumption by demonstrating that a sufficient amount of its financial support comes from "public sources" [small contributions from the general public, grants from governmental agencies, and grants from other public charities].
- **PRIVATE FOUNDATION STATUS:** A "private foundation" is any 501(c)(3) organization that has failed to demonstrate that it is a "publicly charity". <u>CLICK HERE</u> to go to an information page on the IRS website

#### Disadvantages

- can only give money to a public charity
- excise tax on investment income not given away as grants in a timely manner"
- generally, gifts to a private foundation are not tax deductible
- a private foundation cannot receive grants from another private foundation.
- **PRIVATE OPERATING FOUNDATION** A "private operating foundation" is a type of private foundation that might be an attractive option for an organization that can't qualify as a "public charity" yet wants to avoid some of the disadvantages of being a

normal private foundation. Private operating foundations are less rigorously regulated by the IRS than other types of private foundations and, like public charities, they can offer their donors the possibility of getting a tax deduction for donations. Somewhat like a public charity they can qualify for certain types of grants from other private foundations. What distinguishes "private operating foundations" from other types of private foundations is that they must devote most of their resources to the active conduct of its exempt activities (rather than simply making grants out of their investment income). CLICK HERE to get more information from the IRS website.

# **RESTRICTIONS ON 501(C)(3) ORGANIZATIONS:**

- NO UNDUE PRIVATE BENEFIT: The IRS will take away your tax exempt status if feels that the primary purpose is to benefit insiders or an overly small group of people rather that the exclusive furtherance of charitable purposes. This can happen when an insider enters into an arrangement with the nonprofit and receives benefits greater than she or he provides in return. The IRS refers to such insiders as "disqualified persons" high-level managers, board members, founders, major donors, highest paid employees, family members of any of the above, etc. This is called "private inurement". It can take many forms. Examples include unreasonably high salary payments and certain types of business dealings between the corporation and its directors and officers. This is a MAJOR concern of the IRS and many of the questions on the application (Form 1023) have to do with potential private inurement.
- LOBBYING: the basic rule is that a 501(c)(3) organization cannot attempt to influence legislation either by directly contacting decision makers or indirectly by urging others to do so. This includes local legislation pending before a city or county commission.
  - An "insubstantial" or incidental amount of lobbying is permitted if an organization is a
    public charity [see definition below]. These terms are difficult to quantify. Five
    percent is sometimes use used as an informal guideline, i.e., an organization's staff
    should not devote more than 5% of its time and or 5% of the organization's annual
    budget for lobbying. But this is not an official IRS guideline.
  - However, there is a "safe harbor". A public charity can make lobbying expenditures
    up to certain specified levels if it makes an "election" with the IRS using the
    designaged form. Even if the organization exceeds the specified expenditure levels,
    the worst that can happen is that it will have to pay a tax of 25% of its excessive
    lobbying expenditures. It doesn't lose its exemption unless it keeps exceeding the
    limits in subsequent years. For more information go to Publication 557.
  - CERTAIN ACTIVITIES ARE NOT TREATED AS "LOBBYING". These include [1] talking to legislators about legislation that might affect an organization's tax exempt status or existence, but this does not include budgetary or funding matters: [2] activities related to non legislative decisions, such as opposing or supporting the issuance of regulations; [3] making available the results of nonpartisan studies; and [4] responding to requests to testify before legislative committees [your organization must be invited in writing by the chairman of the committee].
  - EDUCATING THE PUBLIC MAY NOT BE LOBBYING. Educating the public about an important issue is not lobbying so long as you don't directly urge people to contact their legislators. It is permissible to do "educational" activities such as nonpartisan research, policy papers, websites, newsletters, trainings, conferences, etc.
- NO ENDORSING POLITICAL CANDIDATES: Section 501(c)(3) organizations cannot support or oppose political candidates. No partisan political campaign activities, however

minimal, are allowed. Section 501(c)(3) groups can distribute nonpartisan "voter education" information, but such information should be carefully reviewed to make sure that it is a fair presentation of information about all candidates and is not "slanted". It cannot be anything that can be construed as an attempt to persuade the public one way or the other. Also, Section 501(c)(3) organizations are not permitted to allow groups or individuals to use their facilities and equipment to campaign for candidates.

## **COMPLETING THE APPLICATION (FORM 1023)**

Tip: For additional help in filling out Form 1023 go to Nancy Deja's site: Form1023Help.com

- **STEP 1 Read the Instructions**: Form 1023 has excellent instructions (a separate document from the form itself). Read those instructions carefully. Also, read <u>IRS publication</u> 557.
- STEP 2 Employer ID Number: One of the first questions on the application is your "Employer Identification Number" (EIN) If you don't have one you will need to get it from the IRS. The easiest way to do this is to apply on-line. Or, you can download Form SS4 from the IRS website and follow the instructions.
- STEP 3 Prepare the "Narrative": Part IV of Form 1023 asks you to describe in detail your organization's past, present, and future activities. The "narrative" that you create will be one of the attachments to the completed Form 1023. This is the most important question on the entire application because your answer will determine whether or not you meet the "operational test" (see above).

# Here are some pointers for your "Narrative"

- FIRST SECTION LABELED "BACKGROUND". To help the IRS better understand your activities you can include <u>an optional</u> short section that describes the background or the need that you are trying to address. Tip: label this section "Background" so that the IRS knows that you are not trying to describe the activities themselves
- SECOND SECTION LABELED "ACTIVITIES" (with separate labeled subsections for each distinct activity).. Provide detailed descriptions for each activity. If you fail to give sufficient detail the IRS may hold up approval of your application until you answer all of their written questions. <u>Include in your narrative a discussion of how</u> <u>each activity will achieve an IRS recognized exempt purpose</u> (refer to the listing of approved charitable purposes in the section above labeled:"Operational Test"). For each activity provide the following details
  - Describe the activity in detail
  - Who are the people that will be conducting the activity?
  - Will there be paid employees or paid independent contractors?
  - If so, describe their titles and duties.
  - Where will the activity be conducted? (donated space? leased space? building that is owned?)
  - When is the the activity to be conducted (daily? periodically? weekly?, etc)
  - Who will the activity serve?
  - Who is eligible to participate in the activity?
  - How are participants selected?
  - Are fees charged?
  - If so, please provide a fee schedule
  - If activity involves affordable housing development, give details on the financing, the maximum allowable income levels for the tenants or buyers,

- etc. <u>CLICK HERE</u> to read about the IRS affordable housing "safe harbor" rules
- If the activity involves "economic development", explain why the activity is "charitable" and not for "private benefit". <u>CLICK HERE</u> to read about the IRS rules governing the eligibility of "economic development" activities.
- DISCLOSE ONLY CONCRETE ACTIVITIES. Do not include vague ideas that you
  may or may not implement in the future. Include only those activities that you are
  presently engaged in or will actually implement during the next two years and that
  you can describe with some detail. Remember, if you blurt out some vague
  future plans without providing detail you will be inviting the IRS to ask you
  follow-up questions after you submit the application thus delaying the granting
  of the exemption.

#### • SAMPLE NARRATIVES

- Youth baseball program
- After-school tutoring, summer day-camp
- Mentoring program run by volunteers
- Raising funds to support programs in the public schools
- Economic development activities in low income neighborhoods
- Raising funds for volunteer work in Haiti
- Educating the public on an important issue
- Buying, rehabing, & reselling foreclosed homes as affordable housing
- AVOID "BOOBY TRAPS" WHEN WRITING THE NARRATIVE:
  - INADVERTENTLY IMPLY LOBBYING. Don't inadvertently brag about how
    you plan to go down to City Hall and demand better code enforcement in
    order to clean up the neighborhood (etc.). This could be interpreted by the
    IRS to be lobbying and could trigger follow-up questions from them after you
    submit your application.
  - INADVERTENTLY IMPLYING PRIVATE BENEFIT. The exemption will be
    denied if the IRS determines that the purpose is primarily for private benefit.
    Be careful not to imply in your narrative that benefits that will be enjoyed by
    specified individuals or the organization's membership (unless, of course that
    is to be the case). The activities of an exempt charitable organization must
    primarily be for the benefit of the public and NOT private interests.
    Inadvertently implying private benefit in your narrative will invite a follow-up
    grilling from the IRS after you have submitted your application and thus delay
    approval.
  - INSIDERS RECEIVING COMPENSATION. When evaluating your application the IRS will be looking for indications of compensation being paid to insiders such as members of board of directors and the founder. It is OK to pay reasonable compensation for services actually performed BUT payments to insiders raises concerns about possible impermissible private benefit and could result in closer scrutiny of you application by the IRS which might delay or defeat the granting of the exemption. It is best that anyone receiving compensation NOT be a member of the board of directors.

TIP. Naturally the founders of many new organizations want to some day be a paid employee or consultant after funding becomes available. But you don't necessarily have to mention this in the

<u>narrative</u>. This would be the case where the funding has not yet been obtained and the organization's board of directors has not formally voted to hire or retain any particular individual. Even if the founders have made an informal decision the ACTUAL formal decision by the board will not be made until some future date after the funding becomes available..

- "UNRELATED TRADE OR BUSINESS": Be careful in describing your
  activities in the narrative. You don't want to unintentionally leave the
  impression that an activity is an "unrelated trade or business". <u>Click here for
  short article discussing this issue</u>. This becomes a problem when your
  proposed activity is similar to a non-exempt activity carried on by a for-profit
  business. The bottom line for the IRS is <u>unfair competition</u>. You have to
  convince the IRS that the proposed activity is going to be operated differently
  from any similar activities that might be carried on by for-profit businesses.
  - Some people think that an activity is exempt merely because the profits are to be spent doing something charitable. THIS IS NOT THE CASE. The activity itself must further a charitable purpose.
  - The IRS will allow you to engage in some unrelated trade or business activities so long as it is not "substantial" (you will be required to pay tax on any profits)
- **STEP 4 FINANCIAL INFORMATION.** Complete Part IX -A ("Statement of Expenses and Revenue"). Don't freak out it looks more complicated than it actually is.
  - Initially, ignore "revenue" and focus on "expenses".
  - Don't enter anything onto Form 1023 yet. Instead, create a word processing or spreadsheet file and use it to <u>create a list of the estimated operating expenses for the first year of actual operations</u>.
    - Include things like rent, salaries, telephone, internet connection, professional fees (such as to pay an accountant), travel, postage, etc. Remember, for a new organization guess work is OK.
    - Substitute actual data if the organization has a track record and is gone beyond the start-up phase.
  - Read the instructions for Part IX-A to determine which future or prior years need to be included (it will depend on how long the organization has been in existence).
  - Then, create separate versions of the expense list for each additional year required to be included in Part IX-A.
    - For a start-up there may not be any funding for the initial year so adjust the numbers accordingly. For years subsequent to the first operational year perhaps show the expenses increasing modestly to reflect hoped for increases in grant funding.
  - Now start transferring the expenses over into the appropriate field in Part IX-A
    - Use Caution when Listing Compensation Paid for Services: Try to avoid showing compensation being paid to "insiders"

- You've got four choice on where to show the amount paid
  - item #17 (compensation to officers and directors), or
  - item #18 (salaries and wages), or
  - Item #22 (professional fees), or
  - a combination of the above
- If possible avoid using item #17 because it hints that there might be impermissible "private benefit" going to the organization's insiders. This might cause the IRS to ask additional questions thus delaying the application's approval. Try to include all such compensation in either item #18 or #22. But, don't lie. The IRS will "frown" later on if your lie is discovered during an audit.
- Most other expenses will probably be lumped into items #20 (rent) and #23 (other expenses - requires an itemized listing as an attachment)
- Now, for "revenue". For most organizations typically all revenue will be shown in item #1 ("gifts, grants, and contributions" which includes both government and foundation grants). Obviously for a new organization the source of the funding is not yet know. The IRS understands this. Simply insert into item #1 for each year a number that equals the "total expenses" shown in item #24.
- STEP 5- Conflict of Interest Policy Prepare the Conflict of Interest policy that is a
  required attachment to Form 1023 and have it adopted by the applicant's board of directors.

  <u>Click Here</u> to download the sample conflict policy document recommended by the IRS (it
  must be edited to make it suitable for particular organizations). <u>Click Here</u> for the annual
  statement to signed by each director (only the Conflict of Interest Policy and NOT the
  annual statement are to be attached to the exemption application).

# **FINAL CHECKLIST:**

- On Form 1023, near the end, there is a final checklist page. Assemble your packet for submission following the order of the documents outlined in that checklist. It gives instructions on where to send the application and how to handle the filing fee
- COVER LETTER: prepare a short cover letter to be signed by the corporations president explaining that you are applying for tax exempt status and that your application is attached. Include the following statement: "the attached bylaws are a true and correct copy of the bylaws that are currently in effect".

#### **POST APPLICATION**

- After getting your application the IRS will give it a quick review and then put it on one of two tracks.
  - <u>Fast Track</u>: If it seems clear in the initial review that the applicant is organized and operates exclusively for an exempt purpose and there is no hint of problems (such as private innurment, lobbying, political activity, etc) they will place the application on the fast track for approval and you will be notified of that approval in about four to six weeks.
  - Slow Track: If the initial reviewer perceives issues or red flags the application will be
    assigned to a revenue officer for further scrutiny. In such case approval (if it is
    granted) could take up to nine months or more. You will eventually be contacted and
    asked to answer questions and/or provide additional information. Answer all
    questions truthfully and in detail and submit the answers within the time deadlines

imposed. In their written communications they will tell you the name of the revenue officer and his or her phone number. You should not be shy about calling if you have questions. Often these people are friendly and can be very helpful.

 <u>Determination letter</u>: eventually the IRS will either send you a favorable or an unfavorable determination letter. If it is unfavorable, good luck and you have our condolences. If it is favorable, congratulations! Save this letter. It is very important. Not only does it give you critical information about compliance and staying out of trouble with the IRS, but your potential funding sources will almost always ask you for a copy of it.

#### **ANNUAL INFORMATIONAL RETURN - FORM 990**

- Form 990 series returns are required to be filed by most tax-exempt organizations. Form 990 is the IRS' primary tool for gathering information about tax-exempt organizations, for educating organizations about tax law requirements and ensuring their compliance.
   Organizations use it to inform the public about their programs. <u>CLICK HERE</u> to go to a page on the IRS website that provides more detailed information about the requirements.
- Even near dormant organizations that have engaged in little or no activity are required to file. Often, however, they can get away with a simplified "postcard" filing using Form 990-N -<u>CLICK HERE</u> to go to an information page on the IRS website.

#### SOME IRS PUBLICATIONS THAT WILL BE HELPFUL:

Click Here to go the IRS download page

- IRS Publication 526 Charitable Contributions:Organizations that qualify for status as a charity are described. The publication provides rules for determining the fair market value of donated property and explains limits on the size of a deduction based on 20, 30, or 50% of an individual's adjusted gross income.
- IRS Publication 557 Tax-Exempt Status for Your Organization: (click here for the on-line version). Organizations are guided through the application procedures for obtaining tax-exempt status. Generally, these organizations must complete either Form 1023 or Form 1024 and await a ruling or determination letter from the IRS. If an exemption is granted, it may be effective as of the date of an organization's formation. In some cases, an organization may be issued an advance ruling or determination letter prior to commencing operations. Return and disclosure statements required of exempt organizations are explained.
- IRS Publication 598 Tax on Unrelated Business Income of Exempt Organization:
- IRS Publication 1391 Deductibility of Payments Made to Charities Conducting Fund-Raising Events:Helps sponsors of fund-raising events carefully word the extent of a donor's eligibility for a charitable contributions deduction.
- IRS Publication 1771 Charitable Contributions--Substantiation and Disclosure
  Requirements:The Revenue Reconciliation Act of 1993's substantiation and disclosure
  requirements for donors and charities on contributions made after December 31, 1993 are
  reported. It is recommended that charities familiarize themselves with the new law in order
  to avoid failure to meet disclosure provisions that might be subject them to penalties.