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Federal Tax Exemption and Nonprofits: A Primer for the Non-Nonprofit Attorney

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Nonprofit v. Tax-Exempt Status

- There is a notable difference between a nonprofit organization's "nonprofit" corporate status and its federal "tax-exempt" status; once a "nonprofit" corporation is formed, it does not automatically become federally "tax-exempt"
  - By default, it would be a taxable nonprofit corporation without IRS tax-exemption recognition

- Despite the name, "nonprofits" are not limited in the profits they can earn; it is just that nonprofits have no owners/shareholders and all profits must be reinvested in the corporation in furtherance of its nonprofit mission and purposes

- A nonprofit corporation is organized under the laws of one of the 50 states or DC; most of these laws are largely based on the American Bar Association's Model Nonprofit Corporation Act, the Fourth Edition which is about to be released

Nonprofit v. Tax-Exempt Status – *cont.*

- State nonprofit corporation statutes regulate a wide array of governance, operations and activities of nonprofit corporations, including things that the nonprofit must do and things that it can't do

- State nonprofit corporation statutes also contain "default" provisions in the event that certain matters are not addressed by/in the nonprofit's Articles of Incorporation or Bylaws

- A nonprofit corporation's internal governance rules (e.g., Bylaws, policies) must be consistent with the nonprofit corporation statute of the state of incorporation; the hierarchy is as follows (everything must be consistent with what is above it):
  - State nonprofit corporate statute
  - Articles of Incorporation
  - Bylaws
  - Board- and staff-adopted policies

Federal Tax-Exempt Status – Overview

- The vast majority of all nonprofit corporations are recognized as exempt from federal corporate income tax under Section 501(c)(3) of the Internal Revenue Code; this tax-exempt status provides numerous benefits but also imposes material limitations and prohibitions

- Other nonprofit corporations are recognized as exempt from federal corporate income tax under other sections of the Internal Revenue Code (e.g., Sections 501(c)(6) (trade and professional associations and chambers of commerce), 501(c)(4) (social welfare organizations), 501(c)(5) (labor unions and agricultural organizations), and 501(c)(7) (social clubs))

- Federal tax-exempt status is generally recognized through the filing of an application with the IRS for recognition of such tax-exempt status (e.g., IRS Form 1023 or 1024)

Federal Tax-Exempt Status – Overview – *cont.*

- Most tax-exempt entities are required to file some form of the IRS Form 990 each year – either the Form 990, Form 990-EZ, or Form 990-N, depending on the size of the organization, or Form 990-PF for private foundations – and are required to file the IRS Form 990-T (and make quarterly estimated tax payments) if unrelated business income (UBI) is earned; all such forms are subject to public disclosure

- Tax-exempt entities can earn (and pay federal and state corporate income tax on) UBI but cannot earn more than an "insubstantial" amount of UBI in the aggregate

- Recognition of federal tax-exempt status can generally be utilized to confer virtually automatic exemption from state corporate income tax (in the state in which the organization's principal office is located (not the state of incorporation)); most states require that the tax-exempt entity file a copy of its Form 990 with the state each year

Private Inurement and Intermediate Sanctions

- The “private inurement” doctrine is applicable to most categories of tax-exempt entities, but the “private benefit” doctrine is only applicable to 501(c)(3) and (c)(4) organizations

- The private inurement doctrine prohibits paying excessive compensation (greater than fair market value) to those with an ability to exercise substantial influence over the organization, such as officers, directors and key employees, and sometimes others such as founders

- All tax-exempt entities can potentially lose their tax-exempt status for private inurement, but only 501(c)(3) and 501(c)(4) entities are subject to “intermediate sanctions” (excise taxes)(IRC Section 4958) that can be imposed by the IRS on such excessive compensation – both on the recipients of the compensation and on those who approved it (individually)

Private Inurement and Intermediate Sanctions – *cont.*

- Under the intermediate sanctions rules, excise taxes can be imposed on "excess benefit transactions"; an excess benefit transaction is any transaction in which a Section 501(c)(3) or 501(c)(4) organization provides an economic benefit to a "disqualified person" that has a greater value than what it receives from the person
- This would include providing compensation to a person in excess of the value of the services rendered or selling or renting property to a person for less than the property's sale or rental value; the excess benefit equals the difference of the value of the benefit provided to the person over the value of the consideration received by the organization
- There are two types of intermediate sanctions excise taxes:
  - The first tax is imposed on disqualified persons who receive an excess benefit; the tax is equal to 25% of the excess benefit; there is an additional tax equal to 200% of the benefit if it is not corrected (i.e., paid back to the entity) before the date on which the IRS issues a deficiency notice for the 25% tax
  - The second tax is imposed on "organizational managers" who knowingly, willfully and without reasonable cause participate in (e.g., approve) the excess benefit transaction; this tax is equal to 10% of the excess benefit, but no more than $20,000
- A "disqualified person" is defined as someone who, at any time during the five years preceding an excess benefit transaction, was in a position to exercise substantial influence over the affairs of the tax-exempt organization (e.g., officers, directors, key employees, founders)

Private Inurement and Intermediate Sanctions – *cont.*

- The "rebuttable presumption of reasonableness" can significantly help protect against IRS findings of private inurement and the imposition of intermediate sanctions, and should be a best practice for all tax-exempt entities; it has three steps, all of which much exist to take advantage of this "safe harbor":
    - Compensation should be set in reliance on *appropriate* comparability data;
    - Compensation decisions should be made by *independent* decision-makers, with appropriate recusal by the recipient(s) of such compensation; and
    - This process should be *contemporaneously* documented
- Both intermediate sanctions and revocation of tax-exempt status are possible outcomes from excess benefit transactions / private inurement, but intermediate sanctions are only applicable to 501(c)(3) and 501(c)(4) entities
- Both can only be enforced by the IRS through the audit/examination process; no private right of action

Private Benefit Doctrine

- The private benefit doctrine is only applicable to 501(c)(3) and (c)(4) entities
- It requires that, on balance, a 501(c)(3) or (c)(4) entity must confer more benefits on the public than on private parties, both *quantitatively* and *qualitatively*
- Only "impermissible" private benefit is prohibited – *some* private benefit is inherent in many activities and operations of 501(c)(3) and (c)(4) organizations; it just cannot be any bigger than necessary to effectuate tax-exempt purposes, and the public benefits must outweigh the private benefits
- The only sanction for impermissible private benefit is revocation of tax-exempt status; can only be enforced by the IRS after an audit/examination; no private right of action

Federal Tax-Exempt Status – Other Taxes; Subsidiaries and Affiliates

- Exemption from federal corporate income tax does not automatically confer exemption from other forms of federal, state and local taxes (e.g., unrelated business income tax (UBIT), federal payroll taxes, state and local sales/use taxes and property taxes)
- In most states, cities and counties, 501(c)(3) tax-exempt status is a prerequisite to state sales/use and property tax exemption but there are usually additional requirements as well
- Tax-exempt organizations are permitted to have taxable and tax-exempt subsidiaries and affiliates, both recognized as separate legal entities for federal income tax purposes (both taxable and tax-exempt) and as "disregarded" entities (e.g., LLCs)

Federal Tax-Exempt Status – Other Taxes; Subsidiaries and Affiliates – *cont.*

- Subsidiaries and affiliates are used for a variety of purposes, such as being able to engage in activities prohibited or limited by the parent's tax-exempt status, liability protection, funding opportunities, government grant/contract indirect cost rates, public charity status, joint ventures, to enable multiple owners and facilitate investment and sale, public perception, separate IRS Forms 990, and separate governance structures
- There are limitations and prohibitions on the ability to transfer funds and resources between and among certain tax categories of parents, subsidiaries and affiliates
- Common examples of subsidiaries and (controlled) affiliates include related advocacy arms, related foundations, taxable subsidiaries, chapters, and (single- and multi-member LLCs; there are a variety of mechanisms for exercising direct and indirect control over subsidiaries and affiliates

Federal Tax Exemption – 501(c)(3)

- 501(c)(3) tax-exempt purposes – educational, scientific, charitable, relieving the burdens of government
- Exemption from federal and state corporate income tax on net income
- Benefits: Contributions generally tax deductible by donors as charitable contributions (less the value of benefits received in return); charitable bequests also permissible; eligibility for many federal, state and local government and private foundation grants
- No “private inurement”; subject to intermediate sanctions as well
- No impermissible “private benefit”

Federal Tax Exemption – 501(c)(3) – *cont.*

- No "substantial" lobbying; two different tests (501(h) election (IRC Section 4911) and the no substantial part test)
- No political campaign activities (supporting or opposing candidates for public office)(e.g., this includes volunteer leaders engaging in such activities while wearing their 501(c)(3)"hat")
- Taxation of unrelated business income ("UBIT"); same rules as for most categories of tax-exempt organizations; most common form is advertising income
- Often allows for state and local sales/use and property tax exemption; if a 501(c)(3) has a state sales/use tax exemption certificate, it only relates to the payment of sales/use tax on *purchases,* not to the *collection and remittance* of sales/use tax on sales, and only applies to purchases in that state (not elsewhere)

Federal Tax Exemption – 501(c)(3) – Public Charities v. Private Foundations

- All 501(c)(3) organizations are subdivided into *public charities* and *private foundations*
- Private foundation status is the default unless the organization can meet one of four different public support tests, which primarily focus on whether there are multiple different donors/funders or just one or two principal ones (exception is for "supporting organizations" that support a tax-exempt entity that itself meets one of the other public support tests)
- Public charity status is more advantageous and less restrictive than private foundation status (since private foundations generally have just one primary funder – such as a corporation or family or individual – they are presumably more subject to being used/abused for the benefit of such funder)

Federal Tax Exemption – 501(c)(3) – Private Foundations

- There is a federal excise tax on the net investment income of most domestic private foundations (subject to quarterly estimated tax payments if $500 or more)
- In addition, some of the more notable restrictions and requirements on private foundations include:
  - Restrictions on self-dealing (e.g., sale or leasing of property, loans, paying compensation, reimbursing expenses, providing goods, services or facilities) between private foundations and their substantial contributors and other "disqualified persons" (insiders)
  - Requirements that the foundation annually distribute a certain minimum amount of its assets for charitable purposes (i.e., IRC Section 4942 requires certain types of private foundations to distribute 5% of the fair market value of their assets each year)
  - Limits on their holdings in private businesses
  - Provisions that investments must not jeopardize the carrying out of tax-exempt purposes
  - Provisions to ensure that expenditures further tax-exempt purposes
  - Prohibition on lobbying and political campaign activity
- Violations of these restrictions and requirements can give rise to taxes and penalties against the foundation, and, in some cases, its managers, substantial contributors, and certain related persons
- IRS Form 4720 must be filed by the foundation to report instances of self-dealing, along with corrective measures being taken (e.g., repayment of funds to the foundation)

Federal Tax Exemption – 501(c)(6)

- 501(c)(6) tax-exempt purposes – to promote, further and advance the industry or profession represented by the organization; most are trade or professional membership associations or chambers of commerce
- Exemption from federal and state corporate income tax on net income
- Contributions not tax deductible as charitable contributions but *usually* will be tax deductible as ordinary and necessary business expenses
- No "private inurement" – i.e., no payment of greater-than-fair-market-value compensation to "insiders" (those with an ability to exercise substantial influence over the organization, such as directors, officers and key employees), but no intermediate sanctions available to the IRS

Federal Tax Exemption – 501(c)(6) – *cont.*

- Political campaign activities (supporting or opposing candidates for public office) cannot constitute more than *half* of the organization's overall activities – distinguished from lobbying, which has no limitation for 501(c)(6) organizations as long as mission-related; 501(c)(4) organizations subject to the same limitation on political campaign activities
- Taxation of unrelated business income ("UBIT"); OK to earn UBI but cannot be more than "insubstantial"; net income is taxed at the flat 21% federal corporate income tax rate; most common form is advertising income; numerous exceptions to UBIT (e.g., royalties, corporate sponsorships, convention and trade show income, investment income, certain capital gains, non-debt-financed rent, volunteer labor exception, sale of donated goods)
- Subject to the federal lobbying tax law (IRC Section 162(e)) which requires 501(c)(6) entities to track their in-house and outside lobbying time and expenses, and then report to their members each year the percentage of their membership dues that are not tax-deductible as a business expense (or pay a "proxy tax" on such lobbying expenses); reportable on the IRS Form 990 as well

Origins and 1950 Congressional Enactment of UBIT Statute

- *C.F. Mueller Company* (1951 Third Circuit Decision) – New York University Law School purchased the C.F. Mueller Company pasta manufacturing company, with all profits from the company dedicated to the Law School and its tax-exempt purposes

- The Third Circuit Court of Appeals reversed the U.S. Tax Court's decision that had held that the Law School was no longer organized and operated exclusively for charitable purposes, relying on the then-"use-of-funds" test, thereby upholding the Law School's position and its tax-exempt status

- In 1950, concerned about unfair competition against taxable entities, Congress enacted the UBIT statute, eliminating the use-of-funds test and imposing today's current UBIT regime, effective 1/1/51; with a few exceptions, the statute has been largely unchanged since then

IRS Definition of Unrelated Trade or Business

The term ’unrelated trade or business’ means, in the case of any organization subject to the tax imposed by section 511, any trade or business the conduct of **which is not substantially related** (aside from the need of such organization for income or funds or the use it makes of the profits derived) **to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 501…**

– Internal Revenue Code Section 513

What Is Unrelated Business Income?

- What is unrelated business income (UBI)? Income from:
  - (1) A trade or business;
  - (2) That is regularly carried on; *and*
  - (3) That is not substantially related to furthering the organization's tax-exempt purposes

- *All* three prongs must be satisfied for UBI to exist; it is a "facts-and-circumstances" test

What Is Unrelated Business Income? (cont.)

- More than "insubstantial" total UBI can jeopardize an organization's tax-exempt status, but alternatives such as taxable subsidiaries are available

- Even if the three prongs of the UBIT test are satisfied, there are numerous specific *exceptions* and *exclusions* from UBI that may apply

Is the Income that is Usually Taxable as UBI

- Income that Is Usually Treated as Unrelated Business Income (UBI):
  - Advertising income (includes ads in periodicals and moving banner advertisements on websites)(nonprofits' programs can be segregated into related and unrelated components for taxation purposes, with periodical subscription sales usually being related and advertising in periodicals almost always being unrelated)(special IRS regulations apply to calculating membership associations' UBIT from periodical advertising)(theoretical advertising exception from UBIT if all ads are strictly tied to all editorial content: *U.S. v. American College of Physicians* (U.S. Supreme Court, 1986))
  - Rental income received from debt-financed property
  - Payments from certain "controlled" entities (e.g., rents or royalties from majority-owned or -controlled subsidiaries)

Exclusions from UBI

- Income that is *specifically excluded* from UBI:
  - Qualified corporate sponsorship income
  - Royalty income
  - Qualified convention and trade show income (open question presently about how/whether *virtual-only* trade shows qualify)
  - Interest, dividends, annuities, and certain capital gains
  - Certain non-debt-financed rental income from real property
  - Volunteer labor (85% or more conducted by unpaid volunteers)
  - Sale of donated goods
  - Certain research income
  - Certain bingo games
  - Renting mailing list to another charitable organization

UBIT – Miscellaneous

- There is a $1,000 corporate income tax deduction for UBIT
- UBI is taxed at the flat corporate income tax rate of 21%
- There is a tax deduction against UBI for directly connected expenses incurred to generate the UBI
- Net operating losses (NOLs) are generally permitted unless recurring for a number of years, which suggests no profit motive (and thus no tax deductibility)
- Tax-exempt organizations can no longer offset losses from one unrelated business activity against gains from another unrelated business activity (profits and losses are determined *per* activity)
- Quarterly estimated tax payments must be made at the federal and state levels for UBIT
- IRS Form 990-T is subject to public disclosure only for 501(c)(3) organizations

Federal Tax Exemption – Public Disclosure Requirements

- All tax-exempt organizations must make available for public inspection certain annual IRS returns and IRS applications for recognition of federal tax exemption, and must provide copies of such returns and applications to individuals who request them (for any or no reason); IRS Form 990-T is subject to public disclosure only for 501(c)(3) organizations
- Copies usually must be provided immediately in the case of in-person requests, and within 30 days in the case of written requests; the tax-exempt organization may charge a reasonable copying fee plus actual postage
- The IRS also must make this same information publicly available
- Specifically, a tax-exempt organization must make readily available for (in-person) public inspection:
  - Its application for recognition of federal tax exemption (Form 1023 or 1024), along with all materials, such as Articles of Incorporation and Bylaws, submitted in support of the application (with certain exceptions), and all correspondence to and from the IRS in connection with the application, including but not limited to the IRS "Determination Letter" affirming the recognition of the organization's tax-exempt status, all questions posed to the organization by the IRS, and the organization's answers to such questions; and
  - Its most recent three annual information returns (e.g., Form 990-T, but only for 501(c)(3) organizations) – including all schedules and attachments filed with such returns – to anyone who requests them; with the exception of private foundations, the organization need not disclose the names or addresses of its donors/contributors

Federal Tax Exemption – Public Disclosure Requirements – *cont.*

- These documents must be made available during regular business hours at the organization's principal office, and at any regional or district offices with three or more employees
- The penalty on the organization for each willful failure to permit public inspection or provide copies of such documents is $5,000 for each information or tax return or application for recognition of federal tax exemption
- In addition, responsible individuals of an organization who fail to provide such documents as required may be subject to a penalty of $20 per day for as long as the failure continues
- There is a maximum penalty on responsible individuals of $10,000 for each failure to provide a copy of an annual information or tax return; there is no maximum penalty for the failure to provide a copy of a tax-exemption application

Federal Tax Exemption – Charitable Substantiation Requirements

- Applicable to 501(c)(3) organizations and other tax-exempt entities eligible to receive tax-deductible charitable contributions (e.g., certain 501(c)(19) veterans' organizations)
- No charitable deduction is permitted for any charitable contribution of $250 or more unless the donors has contemporaneous written substantiation from the charity; in cases where the charity has provided goods or services to the donor in exchange for making the contribution, this contemporaneous written acknowledgment must include a good-faith estimate of the value of such goods or services
- Charities must provide a written disclosure statement to donors who make "*quid pro quo*" contributions in excess of $75; this requirement is separate from the written substantiation for deductibility purposes described above; in certain circumstances, a charity may be able to satisfy both requirements with the same written document
- A *quid pro quo* contribution is a payment made partly as a contribution and partly for goods or services; where a donor gives more than fair market value to a charity for goods or services, only the amount that exceeds the value of the goods or services is deductible as a charitable contribution (presuming *donative intent* exists)

Questions?

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