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501(c)(3) ORGANIZATIONS

OR

HOW YOU WILL LEARN TO STOP WORRYING AND LOVE THE DONATIONS

A. An Organization

The IRS requires some sort of formal structure before it will consider granting not-for-profit status. You need not be an organization that has to register with the state as an entity, such as a corporation or LLC. However, these kinds of entities have the advantage of having a legal structure that is easily recognized as acceptable to the IRS. They cost more in terms of annual state registration fees, but it may be worth the extra expense.

The organization needs to be a not-for-profit organization within the framework of your state law. Each state has its own requirements. In general, the choice to be a not-for-profit happens when the entity is formed under state law. Merely becoming a not-for-profit under state law does not make your organization a tax exempt charity under federal law. The tax status is something that must come from the IRS. Both the state not-for-profit status and the federal tax exempt status must be in place to achieve charitable organization status.

Becoming an entity under state law is achieved with different documents, depending upon the kind of entity chosen. A Charter is how a corporation is generally started. Articles of Organization are generally how an LLC is started. Either way, there must be a positive choice to be a not for profit and appropriate language must be included in both the state registration document and the document setting forth the internal rules under which the entity operates.

The IRS helpfully sets out example language for all such documents. The language may be found on the IRS website: www.irs.gov.

Key issues to consider in starting your organization, no matter what kind of organization it is, are areas where the entity might be used to provide personal gain to those in charge of the organization, or where political activity might be sponsored by the organization. Make sure the money cannot go to provide profit for the officers and directors at all. Make sure the money will not go to anything other than the described activities or another 501(c)(3)-qualified charity. This should not be changeable. You should also say that even at dissolution, any remaining assets may only be distributed to another 501(c)(3).

B. Activity

Do not plan on, or commit, political activity. Churches, a normally unassailable bastion of not-for-profit status, have lost their tax exemption over overt political activity.

Your activity should include educating and informing the public concerning - whatever it is you intend to do. If the organization exists solely for the benefit of the members, the IRS is likely to deny charitable status, or require a major re-writing of the organizational documents and application.

C. Filing

The next question to address is whether or not to file for exemption with the IRS, or at which level to file with the IRS. If your organization's annual receipts are less than \$5,000 and you meet the substantive requirements of 501(c)(3) law, you need not file. This is tested over a three-year period. In the first year you can have up to \$7,500. The second year \$12,000 and the third year no more than \$15,000. If you exceed the marks, you must file within 90 days of the end of your formation year. If you file, you must choose between a filing claiming annual receipts of more, or less, than \$10,000. The filing fee is \$400 if annual receipts are less than \$10,000 in preceding 4 years. The filing fee is \$850 if annual receipts are more than \$10,000 in preceding 4 years.

The issues that are of most concern in making the application are the budget, the purpose, how you intend to go about fulfilling the purpose and choosing your board wisely.

DO NOT pay your directors a substantial salary. Directors should, as a matter of policy, not receive a salary.

DO NOT have one family have a majority on the board. A majority controlled by one family will be considered to be a vehicle for achieving a family purpose, rather than a charitable purpose.

BUDGET. Make a budget for your current year and two into the future, or three from the past. Clearly, if your organization has not previously been in existence, you cannot predict future budgeting with any degree of assurance. The IRS is aware of this and is looking for what portion of the budget of the organization is actually designed to benefit the public.

D. Private Foundation, or Public Charity

The IRS presumes that any entity seeking charitable status is a private foundation. The allure of spending one's own money to benefit the public the way you want has resulted in a proliferation of charitable trusts as part of the tax planning of wealthy individuals. As the individual, not the government, chooses how the money is spent to achieve the stated objective, the government is more interested in limiting the charitable status of the organization, and requiring more detailed filings at the same time.

Sections 509(a)(1) and (a)(2) set out the criteria for being considered a public charity, as

opposed to a private foundation. 509(a)(1) Organizations include churches, colleges & universities, hospitals, endowment funds, and Publicly Supported Organizations:

The IRS set out some tests that they believe separate the foxes from the hens, so to speak. They are:

The One-Third test: Pretty simple. At least one-third of your support comes from the general public. And, if you don't meet the test in any one year, but generally meet the test, it's OK.

Facts and circumstances test. The facts and circumstances test is for organizations failing to meet the one-third support test. If your organization fails to meet the one-third support test, it may still be treated as a publicly supported organization if it normally receives a substantial part of its support from governmental units, from direct or indirect contributions from the general public, or from a combination of these sources. To qualify, an organization must meet the ten-percent-of-support requirement and the attraction-of-public support requirement. These requirements establish, under all the facts and circumstances, that an organization normally receives a substantial part of its support from governmental units or from direct or indirect contributions from the general public. The organization also must be in the nature of a publicly supported organization, taking into account five different factors. See Additional requirements (the five public support factors) , later.

Ten-percent-of-support requirement. The percentage of support normally received by an organization from governmental units, from contributions made directly or indirectly by the general public, or from a combination of these sources must be substantial. An organization will not be treated as normally receiving a substantial amount of governmental or public support unless the total amount of governmental and public support normally received is at least 10% of the total support normally received by that organization.

Attraction-of-public-support requirement. An organization must be organized and operated in a manner to attract new and additional public or governmental support on a continuing basis. An organization will meet this requirement if it maintains a continuous and bona fide program for solicitation of funds from the general public, community, or membership group involved, or if it carries on activities designed to attract support from governmental units or other charitable organizations described in section 509(a)(1). In determining whether an organization maintains a continuous and bona fide program for solicitation of funds from the general public or community, consideration will be given to whether the scope of its fund-raising activities is reasonable in light of its charitable activities. Consideration also will be given to the fact that an organization may, in its early years of existence, limit the scope of its solicitation to persons who would be most likely to provide seed money sufficient to enable it to begin its charitable activities and expand its solicitation program.

Definition of "normally" for facts and circumstances test. An organization will normally meet the requirements of the facts and circumstances test for its current tax year and the next tax year if, for the current tax year and the 4 tax years immediately before the current tax year, the organization meets the ten-percent-of-support and the attraction-of-public support requirements on an aggregate basis and satisfies a sufficient combination of the factors discussed later. The combination of factors that an organization normally must meet does not have to be the same for

each 4-year period as long as a sufficient combination of factors exists to show compliance.

Additional requirements (the five public support factors). In addition to the two requirements of the facts and circumstances test, the following five public support factors will be considered in determining whether an organization is publicly supported. However, an organization generally does not have to satisfy all of the factors. The factors relevant to each case and the weight accorded to any one of them may differ depending upon the nature and purpose of the organization and the length of time it has existed. The combination of factors that an organization normally must meet does not have to be the same for each 4-year period as long as a sufficient combination of factors exists to show that the organization is publicly supported.

1. Percentage-of-financial support factor. When an organization normally receives at least 10% but less than one-third of its total support from public or governmental sources, the percentage of support received from those sources will be considered in determining whether the organization is publicly supported. As the percentage of support from public or governmental sources increases, the burden of establishing the publicly supported nature of the organization through other factors decreases, while the lower the percentage, the greater the burden.

If the percentage of the organization's support from the general public or governmental sources is low because it receives a high percentage of its total support from investment income on its endowment funds, the organization will be treated as complying with this factor if the endowment fund was originally contributed by a governmental unit or by the general public. However, if the endowment funds were originally contributed by a few individuals or members of their families, this fact will increase the burden on the organization of establishing compliance with other factors. Facts pertinent to years before the 4 tax years immediately before the current tax year also may be considered.

2. Sources-of-support factor. If an organization normally receives at least 10% but less than one-third of its total support from public or governmental sources, the fact that it receives the support from governmental units or directly or indirectly from a representative number of persons, rather than receiving almost all of its support from the members of a single family, will be considered in determining whether the organization is publicly supported. In determining what is a representative number of persons, consideration will be given to the type of organization involved, the length of time it has existed, and whether it limits its activities to a particular community or region or to a special field that can be expected to appeal to a limited number of persons. Facts pertinent to years before the 4 tax years immediately before the current tax year also may be considered.

3. Representative-governing-body factor. The fact that an organization has a governing body that represents the broad interests of the public rather than the personal or private interest of a limited number of donors will be considered in determining whether the organization is publicly supported.

An organization will meet this requirement if it has a governing body composed of:

Public officials acting in their public capacities,

Individuals selected by public officials acting in their public capacities,

Persons having special knowledge or expertise in the particular field or discipline in which the organization is operating, and
Community leaders, such as elected or appointed officials, members of the clergy, educators, civic leaders, or other such persons representing a broad cross-section of the views and interests of the community.

In a membership organization, the governing body also should include individuals elected by a broadly based membership according to the organization's governing instrument or bylaws.

4. Availability of public facilities or services factor. The fact that an organization generally provides facilities or services directly for the benefit of the general public on a continuing basis is evidence that the organization is publicly supported. Examples are:

A museum or library that is open to the public,

A symphony orchestra that gives public performances,

A conservation organization that provides educational services to the public through the distribution of educational materials, or

An old-age home that provides domiciliary or nursing services for members of the general public.

The fact that an educational or research institution regularly publishes scholarly studies widely used by colleges and universities or by members of the general public is also evidence that the organization is publicly supported.

Similarly, the following factors are also evidence that an organization is publicly supported.

Participating in, or sponsoring, the programs of the organization by members of the public having special knowledge or expertise, public officials, or civic or community leaders.

Maintaining a definitive program by the organization to accomplish its charitable work in the community, such as slum clearance or developing employment opportunities.

Receiving a significant part of its funds from a public charity or governmental agency to which it is in some way held accountable as a condition of the grant, contract, or contribution.

5. Additional factors pertinent to membership organizations. The following are additional factors in determining whether a membership organization is publicly supported.

Whether the solicitation for dues-paying members is designed to enroll a substantial number of persons in the community or area, or in a particular profession or field of special interest (taking

into account the size of the area and the nature of the organization's activities).

Whether membership dues for individual (rather than institutional) members have been fixed at rates designed to make membership available to a broad cross section of the interested public, rather than to restrict membership to a limited number of persons.

Whether the activities of the organization will be likely to appeal to persons having some broad common interest or purpose, such as educational activities in the case of alumni associations, musical activities in the case of symphony societies, or civic affairs in the case of parent-teacher associations.

Section 509(a)(2) excludes certain types of broadly based, publicly supported organizations from private foundation status. Generally, an organization described in section 509(a)(2) may also fit the description of a publicly supported organization under section 509(a)(1). There are, however, two basic differences.

For section 509(a)(2) organizations, the term "support" includes items of support discussed earlier (under Support, in the discussion of Section 509(a)(1) Organizations) and income from activities directly related to their exempt function. This income is not included in meeting the support test for a publicly supported organization under section 509(a)(1).

Section 509(a)(2) places a limit on the total gross investment income and unrelated business taxable income (in excess of the unrelated business tax) an organization may have, while section 509(a)(1) does not.

To be excluded from private foundation treatment under section 509(a)(2), an organization must meet two support tests.

The one-third support test.

The not-more-than-one-third support test.

Both these tests are designed to insure that an organization excluded from private foundation treatment is responsive to the general public, rather than to the private interests of a limited number of donors or other persons.

One-third support test. The one-third support test will be met if an organization normally receives more than one-third of its support in each tax year from any combination of:

Gifts, grants, contributions, or membership fees, and

Gross receipts from admissions, sales of merchandise, performance of services, or furnishing facilities in an activity that is not an unrelated trade or business, subject to certain limits, discussed below under Limit on gross receipts .

Not-more-than-one-third support test. This test will be met if an organization normally receives no more than one-third of its support in each tax year from the total of:

Gross investment income, and The excess (if any) of unrelated business taxable income from unrelated trades or businesses acquired after June 30, 1975, over the tax imposed on that income.

E. Returns

FILE YOUR RETURNS Just a few days ago the Internal Revenue Service released a listing of approximately 275,000 organizations that under the law have automatically lost their tax-exempt status because they have not filed as legally required for the past three years.

The return, a form 990, or 990EZ, may be found on www.irs.gov, and may be filled in on line.

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