Tax-Exempt Organizations: An Introductory Overview

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Albert and Bertha created a Delaware Corporation known as The Delaware Continuing Legal Education Center ("DCLEC"). DCLEC’s purpose is to provide continuing legal education to attorneys. DCLEC charges $250 per credit hour and does not offer any scholarships. During breaks, DCLEC sells meals and refreshments at prices competitive with local food-service businesses. Albert and Bertha each receive an annual salary of $175K. Finally, the home page of DCLEC’s website contains the slogan, “Support Senator Smith’s Legislation to Provide Government Grants to CLE Providers.”

Should DCLEC qualify for tax exemption under Section 501(c)(3)?
I.R.C. § 501

I.R.C. § 501(a)
An organization described in subsection (c) . . . shall be exempt from taxation . . .

I.R.C. § 501(c)(3)
Corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition . . . or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual, no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation . . . and which does not participate in, or intervene in . . . any political campaign on behalf of (or in opposition to) any candidate for public office.
Five Basic Requirements under Section 501(c)(3)

1. Form (i.e., corporation)
2. Exempt purpose (i.e., charitable, educational)
3. Inurement Restriction
4. Lobbying Limitation
5. Political Campaign Prohibition
What We’ll Cover Today

• Obtaining Tax Exemption Under Section 501(c)(3)
  • Choice of Form: Corporation v. Trust
  • Examples of Acceptable Purposes: Educational and Religious
• Types of Section 501(c)(3) organizations
  • Public Charities v. Private Foundations
• Maintaining Federal Tax Exemption
  • Avoiding private benefit and inurement
  • Lobbying and Political Campaign Activities
  • Unrelated Commercial Activity
Obtaining Tax Exemption
Under Section 501(c)(3)
Choice of Form

501(c)(3): “Corporations, and any community chest, fund, or foundation...”

• According to the Code, these are the acceptable forms for 501(c)(3) organizations.

• *But what about trusts?*
Choice of Form (cont.)

How do we know Section 501(c)(3) organizations can be organized as trusts?

• Treas. Reg. § 1.501(c)(3)-1(b)(2): “For purposes of this section, the term articles of organization or articles includes the trust instrument, the corporate charter, the articles of association, or any other written instrument by which an organization is created.”

• I.R.C. § 170(c)(2): permits charitable income tax deductions for contributions to charitable trusts
What are the Acceptable Purposes for a Tax-Exempt Organization?

I.R.C. § 501(c)(3): “organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition or for the prevention of cruelty to children or animals.”
What are the Acceptable Purposes for a Tax-Exempt Organization? (cont.)

• Religious
• Charitable
• Scientific
• Public Safety
• Literary
• Educational
• Amateur Sports
• Child and Animal Welfare

- BJU is an educational organization exempt from income tax under Section 501(c)(3).
- Based on its interpretation of Biblical principles, in the 1970s, BJU adopted various policies aimed at eliminating inter-racial dating on campus.
  - Pre-1971: No African-American applicants
  - Post-1975: Denied admission to African-Americans in interracial marriages/relationships
- IRS informed BJU that it was planning to revoke its tax exemption under Section 501(c)(3).
- BJU initiates litigation, argues revocation violates 1st amendment right to freedom of religion.

- SCOTUS 1983 Decision: “the Government has a fundamental, overriding interest in eradicating racial discrimination in education discrimination that prevailed, with official approval, for the first 165 years of this Nation's constitutional history. That governmental interest substantially outweighs whatever burden denial of tax benefits places on petitioners' exercise of their religious beliefs.”

Should an organization that violates public policy be able to maintain its tax exemption if it otherwise qualifies under Section 501(c)(3)? To what extent do first amendment rights impact tax exemption?
In Detail: Two Popular Purposes under Section 501(c)(3)

• Educational
• Religious
(3) Educational defined

(i) In general. The term educational, as used in section 501(c)(3), relates to:

(a) The instruction or training of the individual for the purpose of improving or developing his capabilities; or

(b) The instruction of the public on subjects useful to the individual and beneficial to the community.

An organization may be educational even though it advocates a particular position or viewpoint so long as it presents a sufficiently **full and fair exposition of the pertinent facts** as to permit an individual or the public to form an independent opinion or conclusion. On the other hand, an organization is not educational if its principal function is the mere presentation of unsupported opinion.
Does the “Full and Fair Exposition” Standard Violate the First Amendment?

*Big Mama Rag v. United States, 631 F.2d 1030 (D.C. Cir. 1980)*

- IRS denied BMR’s application for tax-exempt status, in part because it failed the FFE test.
- BMR, a feminist newspaper that promoted lesbianism, challenged the denial in District Ct.
- The Court upheld the IRS denial, and BMR appealed, questioning whether the FFE violated its first amendment rights.
Big Mama Rag v. United States, 631 F.2d 1030 (D.C. Cir. 1980)

• The DC Cir. concluded as follows:

“The fact that an organization, in carrying out its primary purpose, advocates social or civic changes or presents opinion on controversial issues the intention of molding public opinion or creating public sentiment to an acceptance of its views does not preclude such organization from qualifying under section 501(c)(3)... The regulation's vagueness is especially apparent in the last clause quoted above. That portion of the test is expressly based on an individualistic-and therefore necessarily varying and unascertainable-standard: the reactions of members of the public. . . The Treasury regulation defining "educational" is, therefore, unconstitutionally vague.” [text out of order]

To qualify as educational, must an organization present a full and fair exposition of all viewpoints?
The IRS Response: Rev. Proc. 86-43

• In response to its loss in BMR, the IRS adopted the methodology test, looking at an organization’s educational method instead of its message:

  • “The presence of any of the following factors in the presentations made by an organization is indicative that the method used by the organization to advocate its viewpoints or positions is not educational:

    • The presentation of viewpoints or positions unsupported by facts is a significant portion of the organization's communications.
    • The facts that purport to support the viewpoints or positions are distorted.
    • The organization’s presentations make substantial use of inflammatory and disparaging terms and express conclusions more on the basis of strong emotional feelings than of objective evaluations.
    • The approach used in the organization’s presentations is not aimed at developing an understanding on the part of the intended audience or readership because it does not consider their background or training in the subject matter.”
• Could a hate group obtain tax exemption under the “methodology test?”

• *National Alliance v. U.S.*, 710 F.2d 868 (D.C. Cir. 1983) (Court upholding IRS denial of exempt status to white supremacist group agreeing that NA did not rationally develop a viewpoint or develop and did not engage in any “intellectual exposition.”)
Exemption for Religious Purpose

- Reg. 1.501(c)(3)-1(d)(2) identifies “advancement of religion” as a charitable purpose, but there is no broad definition as with educational organizations.
- Book publishers, broadcasters, burial societies, etc. may all be considered religious.
- There is often overlap between categories; for example, some organizations may be both educational and religious.
What’s the Difference between Religious and Church?

• Churches are a subset of “religious” charities that are entitled to the following special treatment:
  • Not required to file formal exemption applications (IRC § 508(c)(1)(A))
  • Presumed not to be private foundations (IRC § 508(c)(1)(A))
    • We’ll discuss the distinction between private foundations and public charities next.
  • Not required to file Form 990 with the IRS (IRC § 6033(a)(2)(A)(i)).
Problem: What’s a Church?

Several devout Christians formed the Ministries of the Lord, an organization exempt from income tax under Section 501(c)(3). The organization does not have a regular meeting place or prayer book, but instead sponsors its members to travel the world to conduct prayer services in any form and to proselytize about the New Testament.

Should this organization qualify as a church?
IRS Definition of Church

The Service considers all the facts and circumstances in determining whether an organization is a church, including whether the organization has the following characteristics:

- a distinct legal existence
- a recognized creed and form of worship
- a definite and distinct ecclesiastical government
- a formal code of doctrine and discipline
- a distinct religious history
- a membership not associated with any other church or denomination
- a complete organization of ordained ministers ministering to their congregations
- ordained ministers selected after completing prescribed courses of study
- a literature of its own
- established places of worship
- **regular congregations**
- **regular religious services**
- Sunday schools for religious instruction of the young
- schools for the preparation of its ministers

Cite: **IRM 7(10)69, Exempt Organizations Examination Guidelines Handbook**, text 321.3(3)
Choice of Form: Private Foundations and Public Charities
(a) **GENERAL RULE.** For purposes of this title, the term “private foundation” means a domestic or foreign organization described in section 501(c)(3) other than —

1. an organization described in section 170(b)(1)(A) (other than in clauses (vii) and (viii));
2. an organization which—
   - (A) normally receives more than one-third of its support in each taxable year from any combination of—
     - (i) gifts, grants, contributions, or membership fees, and
     - (ii) gross receipts from admissions, sales of merchandise, performance of services, or furnishing of facilities … and
   - (B) normally receives not more than one-third of its support in each taxable year from the sum of—
     - (i) gross investment income (as defined in subsection (e)) and
     - (ii) the excess (if any) of the amount of the unrelated business taxable income (as defined in section 512) over the amount of the tax imposed by section 511;
3. an organization which—
   - (A) is organized, and at all times thereafter is operated, exclusively for the benefit of, to perform the functions of, or to carry out the purposes of one or more specified organizations described in paragraph (1) or (2) . . .
Explaining I.R.C. § 509(a)

All tax-exempt organizations are private foundations unless they can meet one of the three “escape routes” in Section 509(a):

• **509(a)(1):** “Traditional” Public Charities that receive at least one third of their total support from the general public.

• **509(a)(2):** “Alternate Public Support Test” – generally for charities with lots of program service revenue but smaller amounts of contributions
  - Theaters and museums are good examples (though many also meet the first test)

• **509(a)(3):** “Supporting Organizations” – organizations that “piggyback” on the tax-exempt status of an organization described in 509(a)(1) or (2) that are created to support one of these such organizations. To qualify, the supporting organization must have a parent/child- or brother/sister-like relationship with the 509(a)(1) or (2).

• **Additional Exception:** Churches are presumed to be public charities and do not need to meet one of the above tests. IRC § 508(c)(1)(A).
Benefits of Public Charity Status

Public charities are not subject to many strict and burdensome rules applicable only to private foundations, including:

• Tax on Investment Income (IRC § 4940): Private foundations pay a 1-2% annual excise tax on their investment income.

• Self-Dealing (IRC § 4941): Prohibits many transactions – even at fair-market value – between a charity and disqualified person.

• Minimum Distribution Requirement (IRC § 4942): Private foundations must distribute 5% of their endowment to qualified organizations every year.
  • Public charities are often the recipients
Maintaining Federal Tax Exemption
Four Important Requirements to Maintain Tax Exemption

1. Avoiding private inurement
2. Prohibition against political campaign activity
3. Not engaging in substantial lobbying activity
4. Commercial Activity
Prohibition against Private Inurement

IRC § 501(c)(3): "no part of the net earnings of which inures to the benefit of any private shareholder or individual…”

Reg. § 1.501(c)(3)-1(c)(2): "An organization is not operated exclusively for one or more exempt purposes if its net earnings inure in whole or in part to the benefit of private shareholders or individuals.”
Problem: Is This Private Inurement?

William has organized a charity known as, Baseball For All, which is classified as a public charity under Sections 509(a)(1) and 170(b)(1)(A)(vi).

Identify whether the following transactions constitute private inurement:

• The Board approves an annual salary of $160,000 for William, who will serve as Executive Director.

• William owns a baseball manufacturing company; his company sells baseballs to BFA at the same price it sells them to the general public.

• William authors a book on baseball coaching, which he licenses to BFA in exchange for a 15% royalty stream on all sales of the book by BFA in the United States.
Political Campaign and Lobbying Activities

• Although Section 501(c)(3) organizations are absolutely prohibited from conducting any political campaign activities, they may conduct lobbying activities provided those activities don’t form a “substantial part” of the organization’s activities. Two tests to determine “substantial part”:
  
  • Facts and circumstances test (*Haswell v. U.S.*, 205 Ct. Cl. 421 (1974) (percentage of budget; employee time; continuous or intermittent nature of activity)
  
  • Safe Harbor Test (501(h) Expenditure Test) (examines dollars spent on lobbying in relation to overall revenue)
  
• Section 4912(d)(1) imposes an excise tax on organizations that spend excess amounts on lobbying; revocation of exemption is also possible.
Problem: Are these prohibited activities?

Lake River Hospital is an exempt organization. One of the “hot” issues in the presidential campaign is a bill that would increase funding for hospitals. Presidential candidate Larry supports the bill.

Will any of the following activities jeopardize LRH’s tax exemption?

• Hosting a campaign event for Larry in the hospital’s auditorium.
• The homepage of LRH’s website says, “support the bill to increase funding for hospitals” with a link that takes the viewer to a page to contact their congressman.
• The president of LRH hosts a fundraiser for Larry in her private home.
Commercial Activity

IRC § 501(c)(3): “organized and operated *exclusively* for religious, charitable, scientific...”

*Treas. Reg. 1.501(c)(3)-1(c)(1): Primary activities.* An organization will be regarded as *operated exclusively* for one or more exempt purposes only if it engages primarily in activities which accomplish one or more of such exempt purposes specified in section 501(c)(3). An organization will not be so regarded if more than an *insubstantial part* of its activities is not in furtherance of an exempt purpose.

Two questions: (1) Can commercial activities qualify for exempt purposes? (2) Can an organization perform any amount of unrelated commercial activity?

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<tr>
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<th>Related Commercial Activity</th>
<th>Unrelated Commercial Activity</th>
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<td>Insubstantial Amount</td>
<td>OK</td>
<td>Possible UBTI</td>
</tr>
<tr>
<td>Substantial Amount</td>
<td>OK</td>
<td>Revocation of Exemption</td>
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Unrelated Business Income Tax

IRC § 511(a)(1): There is hereby imposed for each taxable year on the unrelated business taxable income (as defined in section 512) of every organization described in paragraph (2) a tax computed as provided in section 11.

IRC § 512(a): The term “unrelated business taxable income” means the gross income derived by any organization from any unrelated trade or business . . . regularly carried on by it.

***There are, however, many exceptions to UBTI. See, e.g., IRC § 512(b).
UBIT: Requirements and Exceptions

Three Requirements
1. Trade or Business
2. Regularly Carried On
3. Not Substantially Related to Organization’s Exempt Purpose

Main Exceptions
1. Passive Income (dividends, interest, royalties, and rents)
2. Volunteer Work/Donated Merchandise
3. Convenience Exception
4. Qualified Sponsorship Payments
Problem

The District Dashers (“TDD”), a public charity recognized under Sections 509(a)(1) and 170(b)(1)(A)(vi), operates a recreational running team.

Will any of the following activities cause UBIT?

• Hosting five fundraisers per year at the same local restaurant.
• Selling advertisements in a program for an annual fundraiser at a bowling alley.
• Selling drinks and snacks at weekly practices and competitions.
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