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Seventh Edition

Rules, Guides, Procedures

Jody Blazek and Jane M. Searing

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*To all the wonderful nonprofit clients, seminar participants,
and fellow CPAs and lawyers who serve nonprofits for asking
the questions that provide fuel for this book.*

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Introduction: An Indispensable Roadmap for the Complex Maze of Tax-Exempt Rules and Regulations

Tax Planning and Compliance for Tax-Exempt Organizations: Rules, Guides, Procedures, Seventh Edition, by Jody Blazek and Jane M. Searing, is a comprehensive and authoritative update to the widely read gold standard in non-profit organization tax planning. It's been exhaustively updated to include the latest changes to the tax code, new IRS rulings, court decisions, and regulations issued since 2020.

You'll learn how to establish eligibility for tax-exempt status and maintain that status through compliant tax preparation and disclosure. You'll also discover how to properly handle mergers and terminations. This resource covers every step of a tax-exempt organization's lifecycle.

This book includes access to an annual supplement to keep subscribers current on changes in IRS policies, court decisions, and related issues, as well as easy-to-use guides that highlight critical concerns, such as tax-exempt eligibility, reporting changes to the IRS, reasonable compensation evaluations, and tax compliance.

An essential inclusion in the libraries of everyone who manages or advises tax-exempt organizations, *Tax Planning and Compliance for Tax-Exempt Organizations* is an indispensable guide for tax and accounting professionals.

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 the private interests of 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 many of the levies that finance government, including income, sales, ad valorem, and other local taxes. This special status recognizes the work these entities perform essentially on behalf of the public. In addition, for charitable nonprofits, labor unions, business leagues, and other types of exempt organizations, the tax deductibility of contributions, and dues paid to them, provides further evidences of the government's willingness to forgo revenue in favor of the benefit of the value these organizations provide. At the same time, deductibility of the amounts provided to exempt organizations whether through contributions, dues, or other program revenue, provides a major source of funds for exempt organizations. 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.¹ Similarly, that portion of the dues a civic association or business league spends on lobbying activity may not be deductible by the members.²

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) reference chart listing all categories of exempt organizations and illustrates the wide variety.

The schedule of nonprofit organizations that qualify to receive tax deductible donations are listed in Exhibit 1.1. Guidance in regulations for many IRC §501 exempt nonprofits specifically require that the organization devote itself exclusively to achieving its defined purpose. *Exclusively* for this purpose does not necessarily mean 100 percent. Whether legislative and election activities, for example, further exempt purpose is based on its educational purpose and facts in which it is conducted.

Additional lists can be found in the following publications on the IRS website on the Internet:

- Publication 78—IRS.Gov Online Tax Exempt Organization Search Tool allows for a search by either name or employer ID number (EIN) of organizations eligible to receive tax-deductible charitable contributions. The list does not include churches, group ruling subordinates, and governmental units that are also eligible to receive deductible donations.

¹See Chapter 21.

²See Chapter 7 and Appendix 2.

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 ¹ or 990-EZ ⁸	No ²
§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, 1023-EZ	990 ¹ or 990-EZ, ⁸ 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-A and/or 8976 ¹¹	990 ¹ or 990-EZ ⁸	No, generally ^{2,3}
§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 ¹ or 990-EZ ⁸	No ²
§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 ¹ or 990-EZ ⁸	No ²

(Continued)

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)(7)	Social and Recreation Clubs	Pleasure, recreation, social activities	1024	990 ¹ or 990-EZ ⁸	No ²
§501(c)(8)	Fraternal Beneficiary Societies and Associations	Lodge providing for payment of life, sickness, accident, or other benefits to members	1024	990 ¹ or 990-EZ ⁸	Yes, if for certain §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 ¹ or 990-EZ ⁸	No ²
§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 ¹ or 990-EZ ⁸	Yes, if for certain §501(c)(3) purposes
§501(c)(11)	Teachers' Retirement Fund Associations	Teachers' association for payment of retirement benefits	1024	990 ¹ or 990-EZ ⁸	No ²
§501(c)(12)	Benevolent Life Insurance Associations, Mutual Ditch or Irrigation Companies, 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 ¹ or 990-EZ ⁸	No ²
§501(c)(13)	Cemetery Companies	Burials and incidental activities	1024	990 ¹ or 990-EZ ⁸	Yes, generally
§501(c)(14)	State Chartered Credit Unions, Mutual Reserve Funds	Loans to members	1024	990 ¹ or 990-EZ ⁸	No ²
§501(c)(15)	Mutual Insurance Companies or Associations	Providing insurance, other than life, to members substantially at cost	1024	990 ¹ or 990-EZ ⁸	No ²
§501(c)(16)	Cooperative Organizations to Finance Crop Operations	Financing crop operations in conjunction with activities of a marketing or purchasing association	1024	990 ¹ or 990-EZ ⁸	No ²
§501(c)(17)	Supplemental Unemployment Benefit Trusts	Provides for payment of supplemental unemployment compensation benefits	1024	990 ¹ or 990-EZ ⁸	No ²

Section of 1986 Code	Description of Organization	General Nature of Activities	Application Form No.	Annual Return to Be Filed	Contributions Allowable?
§501(c)(18)	Employee Funded Pension Trusts (created before June 25, 1959)	Payment of benefits under a pension plan funded by employees	1024	990 ¹ or 990-EZ ⁸	No ²
§501(c)(19)	Post or Organization of Past or Present Members of the Armed Forces	Activities implied by nature of organization	1024	990 ¹ or 990-EZ ⁸	No, generally ⁷
§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	1024	990	No ⁴
§501(c)(22)	Withdrawal Liability Payment Funds	To provide funds to meet liability of employers withdrawing from a multi-employer pension fund	1024	990 or 990-EZ ⁸	No ⁵
§501(c)(23)	Veterans Organizations (created before 1880)	To provide insurance and other benefits to veterans	1024	990 or 990-EZ ⁸	No, generally ⁷
§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 ¹ or 990-EZ ⁸	No
§501(c)(26)	State-Sponsored Organizations Providing Health Coverage for High-Risk Individuals	Provides health care coverage to high-risk individuals	1024	990 ¹ or 990-EZ ⁸	No
§501(c)(27)	State-Sponsored Workers' Compensation Reinsurance Organizations	Reimburses members for losses under workers' compensation acts	1024	990 ¹ or 990-EZ ⁸	No
§501(c)(28)	National Railroad Retirement Investment Trusts	Manages and invests the assets of the Railroad Retirement Account	1024	990	No
§501(c)(29)	Co-op Health Insurance Issuers	A qualified health insurance issuer which has received a loan of grant under the co-op program	1024 and Form 8718 ¹²	990 ¹ or 990-EZ ⁸	Yes ¹³
§501(d)	Religious and Apostolic Associations	Regular business activities; communal religious community	1024	1065 ⁹	No ²
§501(e)	Cooperative Hospital Service Organizations	Performs cooperative services for hospitals	1023	990 ¹	No

(Continued)

EXHIBIT I.1 (Continued)

Section of 1986 Code	Description of Organization	General Nature of Activities	Application Form No.	Annual Return to Be Filed	Contributions Allowable?
§501(f)	Cooperative Service Organizations of Operating Educational Organizations	Performs collective investment services for educational organizations	1023	990 ¹ or 990-EZ ³	Yes
§501(k)	Child Care Organization	Provides care for children	1023	990 or 990-EZ ³	Yes
§501(n)	Charitable Risk Pools	Pools certain insurance risks of 501(c)(3) organizations	1023	990 ¹ or 990-EZ ³	Yes
§501(q)	Credit Counseling Organizations	Credit Counseling Services	1023	990 ¹⁴	No
§521(a)	Farmers' Cooperative Associations	Cooperative marketing and purchasing for agricultural producers	1028 or 1024	1120-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, ¹⁰ 990 or 990-EZ ³	No

¹For exceptions to the filing requirement, see Chapter 16.2 and the Form instructions.

²An 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).

³Contributions to volunteer fire companies and similar organizations are deductible, but only if made for exclusively public purposes.

⁴Deductible as a business expense to the extent allowed by Code §192.

⁵Deductible as a business expense to the extent allowed by Code §194A.

⁶Application 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.

⁷Contributions to these organizations are deductible only if 90 percent or more of the organization's members are war veterans.

⁸For limits on the use of Form 990-EZ, see Chapter 16 regarding general instructions for Form 990-EZ (or Form 990).

⁹Although 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.

¹⁰Form 1120-POL is required only if the organization has taxable income as defined in IRC §527(c).

¹¹Form 8976, Notice of Intent to Operate Under IRC §501(c)(4), must also be electronically filed.

¹²See Rev. Proc. 2015-17, sec. 4.01, 2015-7 I.R.B. 599, as modified and superseded by Rev. Proc. 2023-8, for details.

¹³See IRC §501(c)(29) for details.

¹⁴See IRC §501(q) if the organization provides credit counseling services and seeks recognition of exemption under IRC §501(c)(4). Use Form 1024-A if applying for recognition under IRC §501(c)(4).

- IRS Business Master File (MBF) lists approximately 1.7 million nonprofits registered with the IRS as tax-exempt organizations.
- IRS Automatic Revocation of Exemption List contains organizations that have had their federal tax-exempt status automatically revoked for failing to file an annual return or notice with the IRS for three consecutive years.

For purposes of federal tax exemption, each category has its own distinct set of criteria for qualification. Chapters 2 through 8 discuss the requirements for the most common types of charitable exempt organizations, compare the categories, explain the attributes that distinguish them from each other and consider instances in which they overlap. Chapter 10 first presents the rather complicated rules governing private charitable organizations. Those §501(c)(3) organizations are unable to be treated as public because of their limited funding sources. This is why they are called *private foundations* and are subject to special operating restrictions and sanctions, found in Chapters 11 through 15.

The regulations pertaining to many types of nonprofits that are exempt under IRC §501, including charities, civic associations, social clubs, cemetery companies, fraternal societies, and others, specifically require that the organization devote itself exclusively to achieving its defined purpose. *Exclusively* for this purpose does not necessarily mean 100 percent. Whether political campaign and legislative activities further the exempt purpose of an organization is a question based on its particular facts and circumstances.

The challenging task of applying for recognition of tax-exempt status is considered in Chapter 16. 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. This introductory chapter presents the issues to consider prior to establishing an exempt organization.

Chapter 16 outlines the annual compliance requirements: filing one of the Forms 990, 990-PF, or 990-T; reporting back to the IRS when changes occur; and handling an IRS examination. Appendix 4 contains guides for both charitable and noncharitable organizations to aid with various compliance issues. These guides are designed to be used by nonprofit managers and advisors to remind them of the various ongoing requirements of qualification for exempt status and satisfaction of the various filing requirements. Chapters 17 through 21 cover special issues that face a tax-exempt organization during its life, including:

- Taxation of unrelated business income;
- Relationships with other organizations and businesses;
- Lobbying and electioneering;
- Mergers and terminations; and
- Donor acknowledgement.

Throughout this book, readers will note revenue rulings issued by the IRS have provided important guidance for exempt organizations. These rulings reflect the precedential IRS view on the particular issue involved. Their age reflects an IRS policy, initiated 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, announcement, 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.

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 nearly 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 organization and labor unions are coupled together. Why are 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 8, along with examples of those that qualify for exemption under IRC §501(c)(3) 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 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 Chapter and 19.

(b) Businesslike Behavior

Ironically, to be financially successful, a nonprofit can operate in what may be considered to be a businesslike fashion—efficiently and often profitably. Most of the financial management tools used by for-profit businesses—strategic planning, investment management, responsive organizational structure, budgeting, and others—are appropriately used by a tax exempt entity.

The distinguishing characteristic of an exempt entity 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 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,³ not necessarily on whether it has a deficiency of patient revenues in comparison to its expenditures.

An exempt nonprofit 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 future and 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 distribute roughly 5 percent of the value of their non-charitable assets each year.⁴ There is no specific tax limitation on the amount of assets other types of exempts can accumulate so long as the amount does not evidence a lack of exempt purpose.⁵ 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 organization can operate without a profit motive and still produce a profit! It can pay salaries and employee benefits comparable to those of a nonexempt business. So long as the overall compensation is reasonable,⁶ an exempt entity can offer incentive compensation to its employees. What it normally

³Chapter 6.

⁴IRC §4942.

⁵See §2.2.

⁶Generally, see IRC §49 for public charities, and see IRC §4941 for private charities.

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. A good 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 only membership provided. Others operate on a two-way street. Such revenue activity is not 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 organization 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 organization on the same footing as a competing for profit businesses by imposing a regular income tax on profits from such activity. If the unrelated business activity becomes too substantial, the exempt organization may jeopardize its tax-exempt status. Chapter 17 considers the question of when a business activity is unrelated, describes the level of business activity that may be allowed, and presents the myriads of exceptions and modifications that allow much of the income earned by tax-exempt organizations to escape income taxation.

1.2 Nomenclature

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 track with 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 a private charity based on the information provided. Ongoing classification will depend on data reported on Form 990 or 990-PF in the case of a private foundation. The annual Form 990, Schedule A, data serves to monitor ongoing qualification for public charity status and report the public support ratio.⁷

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.⁸ The primary test is applied by deciding

⁷Regs. §1.170A-9(f)(4)(v) for §509(a)(1) classification and §1.509(a)-3(d) for §509(a)(2) classification.

⁸See Chapter 2.

whether substantially all of the activity is exempt. Except for private foundations, *exclusively* does not mean 100 percent, and *primarily* can possibly 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 often 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.

1.3 Control

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. A business league and a social club, however, can rebate a portion of its accumulated surplus to members upon dissolution, if the accumulation of such a reserve was not its primary purpose. A mutual insurance company may reduce premiums by the profits it earns 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 organization 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 that person's 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 "disqualified persons."⁹ The limited circumstances under which the rule is lifted for reasonable and necessary compensation, which is not excessive, for personal services

⁹IRC §4946.

and other payments to officials associated with the conduct of a foundation's programs are discussed in Chapter 12. In 1996, Congress enacted additional legislation applicable to public charities and social welfare organizations subjecting officials of these organizations¹⁰ to similar standards on the receipt of excessive compensation or other benefits called excess benefit transactions. The special rules that must be followed to document the appropriateness of insider payments are discussed in Chapter 9.

1.4 Role of the Internal Revenue Service

The IRS statistics for 2023, the latest available, reflect the IRS progress toward goals as express in the Priority Guidance Plan it published annually. The Accomplishments Letter includes the numbers reported for the following categories:¹¹

- Examinations completed total 2,464 filings in 2023 including the Form 990 series and associated employment and excise tax returns. Overall 76 percent of returns closed examinations with a tax change; 40 percent of the examinations were picked up from a related party examination.
- Since inception, the IRS has approved 89 of the 622 compliance strategies that have been submitted through the online portal. These are issues approved by the TE/GE Compliance Governance Board intended to identify, prioritize, and allocate resources within the TE/GE filing population for examination or compliance checks with taxpayers.
- The IRS closed 119,491 determination applications in fiscal year 2023, 103,073 of which were approved. This is an approval rate of more than 85 percent. Of the total exemption applications, more than 98,000 were for new IRC §501(c)(3) charitable organizations, and 48,126 utilized Form 1023-EZ.

1.5 Suitability as an Exempt Organization

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 personnel are skilled, and the highest scrutiny applied by the IRS to exempt organizations often occurs when they review Form 1023 or 1024 applications for recognition of exemption. Though not expressed, the goal seems to be to weed out questionable organizations at their inception because the IRS has limited resources for subsequent examinations. Form 1023 was revised in 2017,¹² and a cyber-assisted version to streamline the process was released in 2020. The IRS requires that Form 1023 be completed and submitted electronically through Pay.gov as of May 30, 2020. Readers

¹⁰And also now IRC §501(c)(29).

¹¹IRS Publication 5329 (FY 2023) Accomplishments Letter.

¹²See Blazek, IRS Form 1023 Tax Preparation Guide.

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, there are many considerations. However, the following four questions are ones that if the founders fully consider, they will help determine whether creation of a new tax-exempt organization is warranted or if a different option would better accomplish the founder's goals.

(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 branch may be formed as a member of the group, avoiding the need to seek separate qualification for tax exemption.¹³ 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 an absolute prohibition against involvement in political campaigns and limitations on legislative and grassroots lobbying.¹⁴ 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 businesspeople, such as a professional association or the Lions Club, most often qualifies as a business league.¹⁵ 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 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

¹³See §16.2(e).

¹⁴See Chapter 19.

¹⁵See Chapter 7 and Appendices 1 through 3.

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.¹⁶ 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.¹⁷ Self-dealing and certain other insider transactions may be prohibited,¹⁸ and certain sources of support could result in the exempt organization being designated a private foundation subject to stringent operating requirements.¹⁹

(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 and manage 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 nonprofit? Will the organization operate 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 want 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.²⁰

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 direction may change or funds may become available only for tax-exempt organizations, such as

¹⁶See Chapter 2, Chapters 4 through 8, and Appendices 1 through 3 for rules applicable to various categories of exempt organizations.

¹⁷See Chapter 17.

¹⁸See Chapters 12 and 9.

¹⁹See Chapter 3 and Chapters 10 through 15.

²⁰See Chapter 9.