

Public Charities: Organizing and Operating Requirements

The formation and operation of a charitable organization calls for careful planning to navigate the numerous regulatory requirements for obtaining and maintaining a determination by the Internal Revenue Service that the entity has tax-exempt status. This coveted status (often referred to as “501(c)(3) status”) means that income tax deductions are available to donors for their charitable contributions, one of the primary sources of support for these entities. This article is an introduction to the basic requirements for establishing tax-exempt status for a public charity and for operating the entity within those rules in order to maintain eligibility.

Generally. A corporation, community chest, fund, or foundation may be eligible for tax-exempt status if the following basic requirements are satisfied: (1) the organization is organized and operated exclusively for one or more specified charitable purposes; (2) the organization satisfies a proscription against any inurement of its net earnings to private shareholders or individuals; (3) the charity confines its legislative activities within permissible levels; and (4) political activities are prohibited. The following discussion elaborates on these basic requirements.

Organizational and Operational Tests. In order to qualify for exemption as a charitable organization, an entity must be organized and operated exclusively for one or more specified exempt charitable purposes. Thus, the organization must pass an “organizational test” and an “operational test,” as well as the “exempt purposes” test. The permitted exempt purposes are limited to: religious; charitable; scientific; testing for public safety; literary; educational; fostering national or international amateur sports competition; and the prevention of cruelty to children or animals.

The focus of the organizational test is on the documents which establish the organization as a legal entity, such as the articles of incorporation, trust instrument, or other written instrument by which the charity is created. These instruments must expressly limit the purposes of the organization to one or more of the permitted exempt charitable purposes. In addition, the articles must not expressly empower the organization to engage in activities that are not in furtherance of its exempt purposes, including excessive legislative activities or any political activities. Finally, the instrument should state that the assets of the organization must be dedicated to an exempt purpose, both during its operation and upon dissolution.

The focus of the operational test is on the manner in which the exempt purposes for which the entity was organized are met through its operations and activities. This balancing test

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evaluates whether the entity engages primarily in activities that accomplish one or more permitted charitable purpose or whether more than an insubstantial part of activities is not in furtherance of its stated exempt purpose. Even a single non-exempt purpose, if those activities are substantial by comparison, will result in denial or loss of exempt status.

A common question arising under the operational test pertains to the impact of commercial activities on a charity's exempt status. The answer depends upon the nature and the extent of the commercial activity. While the conduct of a commercial activity that is related to the organization's charitable purposes has no tax impact, the potential adverse consequences of carrying on an unrelated business activity are the loss of exempt status or taxation of the business income. However, if the commercial activity represents only an insubstantial part of the organization's overall activities, the tax-exempt status is not affected, and only the income from the unrelated business activity may be subject to the unrelated business income tax. A good example of such an unrelated business activity is a gift shop in an art museum, where the sales proceeds are an insubstantial part of the charity's overall activities, and the gift shop business does not represent a substantial non-exempt purpose of the organization.

No Private Inurement. The net earnings of a charitable organization may not inure to the benefit of any private shareholder or individual. A charity may not be used for the benefit of private interests, such as designated individuals, shareholders, the organization's creator or the creator's family. This ban on private inurement is designed to prevent those in control of the entity from reaping improper benefits, directly or indirectly, as well as to ensure that charitable organizations actually serve the public interest.

This strict ban on private inurement is enforced in two ways. First, any individual participating in an act of private inurement is subject to a 25% excise tax on the amount of the benefit. Second, if the inurement is so significant that the organization no longer has a primary charitable purpose, the organization will lose its tax-exempt status, with sometimes catastrophic income tax implications for the organizers and donors.

Limitation on Lobbying Activities. Charitable organizations must refrain from exceeding the permissible levels of lobbying activities. Two alternative tests are used to determine whether involvement in the legislative process has been excessive. Under the "substantial part" test, the inquiry is whether the engagement in legislative activities was a substantial part of the activities of the organization, and it is a somewhat subjective test. In addition to

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losing its exempt status for engaging in excessive lobbying under the substantial part test, an organization may be subject to an excise tax on its disqualifying lobbying expenditures.

The “expenditure” test is an objective test, under which certain charitable organizations may elect to have their legislative activities measured based on their lobbying expenditures. The IRS may impose two tiers of sanctions for entities failing the expenditure test. The first is a tax on excessive lobbying expenditures, while the second is a loss of the charitable exemption, a sanction reserved for organizations which regularly expend excessive amounts on lobbying activities.

Prohibition on Political Activities. Charitable organizations are strictly prohibited from participating or intervening in any political campaign on behalf of, or in opposition to, a candidate who is running for public office. In addition to losing its exemption for engaging in political activities, an organization may be subject to an excise tax on its political activities. The IRS also has authority to make termination assessments or to seek injunctive relief in order to prevent flagrant violations of the prohibition against political activities.

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