

THE IRS 501(c)(3)
APPLICATION: A STEP-BY-
STEP GUIDE

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Deciding on Public Charity vs Private Foundation Classification

- Clients often wish to create their own charitable entities which must have a charitable purpose.
- 501(c)(3) organizations and can be divided into two classes: private foundations and public charities

Private Foundations

- Typically have a single major source of funding (usually gifts from one family or corporation)
- Primary activity usually the making of grants to other charitable organizations and to individuals, rather than the direct operation of charitable programs
- Benefits –
 - Control over investments and distributions
 - Family involvement to ensure a legacy of family giving
 - Immediate tax deduction for contributed assets (even though foundation does not distribute all of the assets immediately to other charities)
 - Removal of low basis taxable assets without incurring capital gains taxes.

Private Foundations

- Tax deduction limited to 30% of adjusted gross income (AGI) for cash donations and 20% of AGI for appreciated securities.
- Donor can carry forward any of the unused deduction for an additional 5 tax years.
- Records open to the public.
- Directors can receive compensation

Private Foundations

- Disadvantages to operating a private foundation: Directors must
 - Refrain from acts of self-dealing (§4941 of the Code)
 - Meet minimum distribution requirements of distributing 5% of its assets each year to other charitable causes (§4942 of the Code)
 - Abstain from "excess business holdings" (§4943 of the Code)
 - Abstain from "jeopardizing investments" (§4944 of the Code)
 - Refrain from making certain expenditures (§4945 of the Code)
 - Pay tax on net investment income (§4940 of the Code).

Public Charity

- Organizations which meet the following criteria at §§509(a)(1), (2), (3) or (4) of the Code
 - Churches, hospitals, qualified medical research organizations affiliated with hospitals, schools, colleges and universities;
 - Fundraise and receive contributions from many sources, including the general public, governmental agencies, corporations, private foundations or other public charities;
 - Receive income from activities in furtherance of the organization's exempt purposes; or
 - Actively function in a supporting relationship to one or more existing public charities.

Public Charity

- Tax deduction limited to 50% of adjusted gross income (AGI) for cash donations and 20% of AGI for appreciated securities.
- Donor can carry forward any of the unused deduction for an additional 5 tax years.
- Records open to the public.
- Directors can receive compensation

Public Charity

- 1/3 Support Test:
 - 1/3 of funding must come from a governmental unit or from direct or indirect contributions from the general public.
 - Calculated by using total support as the denominator and public support as the numerator.
 - The numbers used reflect a four year period.

Public Charity

- If fail 1/3 Support Test, then use the Facts and Circumstances 10% test:
 - Must normally receive at least 10% of the total support from
 - Governmental units,
 - Contributions made directly or indirectly by the general public, or
 - Combination of the two.
 - Must maintain a continuous and bona fide program for solicitation of funds from the general public, community, or membership group involved, or
 - Can carry on activities designed to attract support from governmental units or other charitable organizations
 - The numbers used reflect a four year period.

Articles of Incorporation

- Clients often wish to create their own charitable entities.
- The first step is to draft the Articles of Incorporation (also called Certificate of Incorporation and used interchangeably in these materials).
- This Articles of Incorporation is the corporation's organizing document.

Articles of Incorporation

- Governed by both state law and federal law.
- Must be filed with the state where the entity will be located.
- Consult local law before drafting.

IRS requires that the Articles of Incorporation include:

- Name of entity
- Statement of exempt purpose:
 - Limit the corporation's purposes to those described in section 501(c)(3) of the IRC which governs the federal not for profit law.
 - Cannot expressly permit activities that do not further the entity's exempt purpose(s), i.e., unrelated activities.
 - Permanently dedicate its assets to exempt purposes.
- Dissolution clause
- Date the document was adopted

501(c)(3) provides:

- 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 (but only if no part of its activities involve the provision of athletic facilities or equipment), 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 (except as otherwise provided in subsection (h)), and which does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of (or in opposition to) any candidate for public office.

IRS Sample Purpose Language

- “The organization is organized exclusively for charitable, religious, educational, and scientific purposes under section 501(c)(3) of the Internal Revenue Code, or corresponding section of any future federal tax code.”

Most common types of 501(c)(3) organizations are:

- Charitable
- Educational
- Religious

Stating one of the 501(c)(3) purposes in the Articles of Incorporation:

- Stating the purpose of the organization is “relief of the poor” would properly limit its tax exempt purpose.
- Stating for example, “relief of the elderly within the meaning of section 501(c)(3).”

Organizational Test

- Articles of organization must limit the organization's purposes to one or more of the ones stated in 501(c)(3) of the Code
- Must not state that the entity can carry on activities that do not further one or more of those purposes.

Examples

- At page 25, Publication 557 provides eight examples of what satisfies the criteria to have a tax exempt purpose in the entity's Articles of Incorporation.
- See pages 12-13 of written materials for these examples.

Key Components of the Articles of Incorporation

- Each state has its own requirements.
- Each state's statutes and forms should be reviewed before drafting.

Articles of Incorporation contain the following information:

- 1. Name of corporation.
- 2. Statement of purpose.
- 3. Location of office.
- 4. Contact information for initial directors.
- 5. Appointment of registered agent.

Articles of Incorporation contain the following information (cont.):

- 6. Other information such as any information which the corporation is permitted but not required to provide and can include IRS language.
- 7. Name and contact information for incorporator.
- 8. Executed by incorporator.

Bylaws

- Bylaws are the tool for governance of a not for profit.
- Contain provisions to conduct of the affairs of the corporation.
- Provide guidance to the directors and officers on how to act.
- Third parties can look top the Bylaws for verification that action is allowed and properly taken.

Bylaws

- No Federal mandated language for Bylaws.
- State laws govern the provisions - before drafting review the specific's state law which will be governing the entity.
- Roadmap for a not for profit organization's operation.

Choosing a Membership or Non-membership Structure

- Whether to have members or not to have members is a decision to be made initially when formed.
- Later as the entity evolves, the structure can be changed to either add or delete members.
- Most states do not require not for profits to have members.
- When forming, review local law as to whether the state requires members.

Choosing a Membership or Non-membership Structure

- Will the governance will be efficiently managed by its Board or whether the governance will be open to members?
- Will the corporation have members or will all powers be vested in a board of directors?
- In general public charities are often not membership organizations and decision making is made by their Boards.

Defining Board Meeting Functions and Structure

- Purpose of the organization
- Number of, election, succession and terms (limits, staggered, etc.) of Directors
- Management, duties and action of the Board and must they be physically present to act
- Board meetings – notice, conduct, procedure and location
- Types, election, succession and terms (limits, staggered, etc.) of Officers

Defining Board Meeting Functions and Structure

- Duties, powers and responsibilities of each officer
- Committees including whether the chairperson (or president) has the power to appoint committees, and to provide for rules, powers, and procedures of such committees
- Liability and indemnification of Officers and Directors
- Location of office
- Removal and disqualification of Directors and Officers

Defining Board Meeting Functions and Structure

- Compensation of Directors and Officers
- Quorum for the transaction of business
- Minutes, book keeping, reviewing corporate records and dispersing funds
- Amendment procedure
- Dissolution procedure

Nonprofit corporations with Voting Members Bylaws Contain Additional Provisions:

- Classes and qualifications of membership
- Rights of membership
- Removal of members
- Actions of the members
- Membership meetings – notice and conduct
- Quorum for the transaction of business

Outlining Membership Provisions

- Types of membership classes
- Eligibility of membership
- Dues structure
- Membership requirements
- Disciplinary procedures
- Resignation
- Duties of members

Conflict of Interest Policy

- Page 9 of Form 1023 instructions of the Form 1023 states “A “conflict of interest” arises when a person in a position of authority over an organization, such as a director, officer, or manager, may benefit personally from a decision he or she could make.”
- Tool to help a not for profit handle situations when a conflict of interest arises.
- Provides a set of guidelines to use to avoid the possibility that those in power receive inappropriate benefits.
- Make it more likely that the entity “will operate for the benefit of the community and not for private interests.” See page 19 of Form 1023 instructions.
- Not required under the Code in order to obtain tax exempt status but implied that it is mandatory – Sample Found at Appendix A of the Instructions to the Form 1023.
- Procedures in place to aid in negotiations, including how to evaluate transactions.

Organizations Eligible to File the New Form 1023-EZ

- The IRS issued a new form 1023-EZ, Streamlined Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code, which can be used in certain situations.
- Most efficient way to determine if the entity qualifies, is to complete the Eligibility Worksheet found at the end of the instructions. If you answer “Yes” to any of the worksheet questions, then you may not use this Form and you must use the Form 1023 to apply for tax exemption
- Useful tool for client planning to use a Foundation in the near future or upon death.
- Saves money and time.
- Must register for an account on Pay.gov, enter "1023-EZ" in the search box and then complete the form.
- The Form must be submitted electronically.

Obtaining a Federal EIN

- Each tax exempt entity must have an Employer Identification Number (“EIN”).
- Functions like a social security number does for individuals and used for income tax returns, opening bank accounts, etc.
- Application can be made online on IRS website once the entity is legally formed.
- Before applying, complete a Form SS-4 Application for Employer Identification Number (EIN).
- Client should sign an EIN Authorization Form that allows the attorney to make the application on behalf of the client.

Obtaining a Federal EIN

- Must state the identity of the “Responsible Party” who is the “person who has a level of control over, or entitlement to, the funds or assets in the entity that, as a practical matter, enables the individual, directly or indirectly, to control, manage or direct the entity and the disposition of its funds and assets.” See Instructions for Form SS-4 at page 3.
- Online form asks whether the individual filing is the Responsible Party or whether it is a third party applying for an EIN on behalf of this corporation.
 - If individual is applying, then at the end of the application process, the IRS will issue the EIN letter assigning the EIN to the entity and you can save it and print it at that time.
 - If third party applying, then the EIN letter will be mailed to the client.
 - In both cases, the EIN will be assigned at the end of the application. Application can be made online on IRS website once the entity is legally formed.

Form 1023 Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code

- Application for securing tax exempt status for the entity.
- Must be filed within 27 months from the end of the month in which it was organized. An entity that is not a private foundation must file a Form 1023 within 90 days of the end of the tax year in which its annual gross receipts are more than \$5,000.
- Requires many exhibits including the entity's Articles of Organization showing proof that the Articles of Incorporation were filed with the state.

Completing Form 1023

- The Form 1023 can be found on the IRS website
- Also need to complete a Federal Power of Attorney Form - Form 2848. Without this form, the attorney will not be able to communicate with the IRS during the tax exempt application process. Also prepare Form 8821, Tax Information Authorization, so that the IRS can provide information about the application to someone other than Officers or Directors of the entity.
- The Form 1023 contains a checklist and which must also be attached to the application.
- Will need to prepare attachments that contain additional information.
- When completing Part IV. Narrative Description of Your Activities, the attorney must be careful not to repeat the purpose clause from the Articles of Incorporation.

IRS Processing Procedures

- IRS tax specialist may request additional information.
- Applications are processed in the order received.
 - Form 1023-EZ – within 90 days from the date of submission. After 90 days, call the IRS at 877-829-5500 to check on the status.
 - Form 1023 – within 180 days from the date of submission. After 180 days, call the IRS at 877-829-5500 to check on the status.
- An application for tax-exempt status can be expedited if there is a compelling reason.
 - Pending grant, where failure to secure the grant will have an adverse impact on the organization's ability to continue operating.
 - Newly created organization providing disaster relief to victims of emergencies.
 - IRS errors have caused undue delays in issuing a determination letter.

IRS Processing Procedures

- IRS will issue a Determination Letter stating that the entity was granted tax exempt status and it provides its public charity classification.
- Entity can still operate while waiting for the Determination Letter.
- Donors may make donations to the entity and be told that donations will be tax deductible retroactive to date of incorporation once application is approved.
- Start up period may require additional out of pocket funding until donors can be tapped for main source of funding.
- Various income tax returns may be due during this period.

Working with Professionals

- Many compliance procedures that should be followed.
- Work with an accountant who is familiar with not for profits.
- Work with attorney knowledgeable of the ongoing compliance and rules regarding various transactions.
- Required Filings and ongoing compliance:
- A) Annual Board of Director Meetings, Annual Conflict of Interest Policy Statement, New York Form 500 Annual Filing for Charitable Organizations, unrelated business income tax filings (if in New York, check each state for specific state filings), employment taxes and other returns and reports that an organization may have to file.
- B) For entities which run on a calendar year, tax returns (Forms 990, 990-EZ, 990-PF, or 990-BL), are due on May 15th of each year. The forms and instructions can be found on the IRS website: www.irs.gov.

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Working with Professionals

- D) Attorney and/or client may wish to read IRS Publication 4221-PC, Compliance Guide for 501(c)(3) Public Charities. Tax returns are available to the public.
- E) In the event of an IRS examination, the IRS agent will use the Form 14114 Governance Check Sheet which is a useful guide for internal review of the well-being of the entity. The client should consider completing it annually and then sharing the information with the accountant and attorney.

This presentation is for informational purposes only and is not intended as a substitute for legal, accounting or financial counsel with respect to your individual circumstances.

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