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D.C. Nonprofit Formation & Governance: Part 2 (Tax-Exempt Status)

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In partnership with the D.C. Bar Pro Bono Center

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Limits of This Presentation

This presentation reviews general principles related to federal tax-exempt status and, where needed, refers to D.C. law.

The information covering federal tax-exempt status will be relevant to all nonprofits, but your particular jurisdiction may also have state and local tax-exempt status provisions.

This presentation does not fully address the many other legal issues that may be relevant to nonprofits, including:

- employment law matters
- intellectual property laws
- complex ownership structures
- regulation of nonprofit relationships with for-profit entities
- fundraising rules and regulations in each state
- lobbying and campaign activity restrictions

Initial Checklist

FORM A LEGAL ENTITY	Incorporate a legal entity and prepare governance documents under the relevant state laws.
OBTAIN AN EIN	Obtain an Employer Identification Number (“EIN”) from the IRS so that you can open a bank account.
APPLY FOR TAX- EXEMPT STATUS	Prepare and submit your applications for federal, state and local tax-exempt status.
APPLY FOR A BBL	Nonprofits in D.C. must apply for and receive a basic business license (BBL) with a “Charitable Solicitation” endorsement before they can legally solicit contributions from D.C. residents.
CONSIDER OUT-OF-STATE AUTHORIZATIONS	Apply for authorization to do business and to solicit charitable contributions in any relevant jurisdiction outside your home state. D.C. nonprofits should likely be licensed in Maryland and Virginia.

1. Federal Tax-Exempt Status Basics

Tax-Exemption Basics

Following formation, your corporation may apply to the IRS (and to state and local governments, if relevant) for tax-exempt status under Section 501(c)(3) of the Internal Revenue Code.

Tax-exempt status means that (i) your nonprofit will be exempt from paying federal corporate income tax on income generated from activities that are substantially related to your nonprofit's purpose and (ii) contributions to your nonprofit may be tax deductible to donors (subject to certain limitations).

Your nonprofit will be subject to Unrelated Business Income Tax ("UBIT"), as well as federal payroll and state and local unemployment, real estate, personal property, sales and use and franchise taxes, as well as excise taxes on lobbying activities (unless exempt under state and local laws).

If, for example, the ability to engage in significant lobbying activity is important, you could apply for tax-exempt status under other statutes, e.g., Section 501(c)(4). Contributions will not be deductible.

In most cases, exemption from state and local taxes is not dependent on exemption from federal taxes, but it may be more efficient to wait until your organization has received its federal tax-exempt status designation before applying for state and local tax-exemption.

Check state and local laws to see if you need to and can apply for exemption from those taxes.

Organizational and Operational Tests

In order to obtain and retain U.S. federal tax-exempt status, an organization “must be both organized and operated exclusively” for one or more of the *tax-exempt purposes* listed in Section 501(c)(3).

These include 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.

ORGANIZATIONAL

- To be “organized exclusively for one or more exempt purposes,” the Articles of Incorporation must:
 - i. limit the purposes of the organization to one or more exempt purposes,
 - ii. not expressly empower the organization to engage (other than as an insubstantial part of its activities) in activities that are not in furtherance of one or more exempt purposes or to devote more than an insubstantial part of its activities to lobbying and
 - iii. provide that, upon the dissolution of the organization, its assets will be distributed for one or more exempt purposes.

OPERATIONAL

- An organization will be treated 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”.
- An organization will not satisfy this requirement if more than an insubstantial part of its activities does not further an exempt purpose or if its activities are too commercial in nature.
- This is a perpetual requirement, and if the IRS determines that an organization has failed this requirement, the organization’s tax-exempt status could be revoked.

Public Charity v. Private Foundation

IRS divides organizations that are tax exempt under Section 501(c)(3) into *private foundations* and *public charities*.

We often view public charities as organizations formed to perform charitable work, with private foundations intending to support (but there are lots of exceptions!).

PUBLIC CHARITY

- Must satisfy a “public support” requirement, which generally requires a broad donor base (generally at least 33% from relatively small donors, other public charities, or the government)
- Can receive donations from other public charities
- Benefits from higher donor tax-deductibility limits
- Requires a diverse, independent board of directors
- Must file one of the three Form 990 options annually (990-N, 990-EZ, 990) depending on annual gross receipts

PRIVATE FOUNDATION

- Generally characterized by small donor base
- Subject to more stringent financial, tax and reporting obligations
- Subject to minimum annual asset distributions
- Increased limitations on deductibility of donations
- Can be governed by a small group (an individual or family)
- Must file Form 990-PF annually

Private foundation status is the default status under Section 501(c)(3), unless you demonstrate otherwise.

Restrictions: Private Benefit & Private Inurement

*A Section 501(c)(3) organization must not be organized or operated for the **benefit of private interests**, such as the creator or the creator's family, . . . or persons controlled directly or indirectly by such private interests. No part of the net earnings of a section 501(c)(3) organization **may inure to the benefit of any private shareholder or individual**. A private shareholder or individual is a person having a personal and private interest in the activities of the organization.*

PRIVATE BENEFIT

- Occurs where the assets of the tax-exempt organization advance a private (insider or otherwise) versus public interest
- Viewed broadly, and may be permitted if incidental to the accomplishment of exempt purposes
- Permitted examples include the lakefront property owners who improve water quality at a publicly-used pond; a food pantry that serves homeless individuals

PRIVATE INUREMENT

- Occurs when an insider – one who has significant influence over the nonprofit – receives benefits greater than they provide
- Viewed in absolute terms; may result in excise taxes (“intermediate sanctions”) or revocation of tax-exempt status
- Most common example is excessive compensation; note also that D.C. prohibits loans to directors and restricts loans to officers
- Permits payments to individuals as reasonable compensation for goods or services or as reimbursement for expenses

Restrictions: Executive Compensation

**Must be reasonable, based on the market for the individual's services.
Otherwise... it is an excess benefit transaction.**

Nonprofits must disclose whether the process for determining compensation of top management official and other officers or key employees includes the following:

- Review and approval by governing body or authorized compensation committee
- Use of appropriate comparability data for similarly qualified persons in comparable positions at similar organizations in similar geographies
- Whether contemporaneous recordkeeping was kept of deliberations and decisions, and the compensation is properly reported on the Form 990, if required

Can result in penalty taxes on individuals who receive the excess benefit and on the organizational managers who knowingly approve a transaction that gives rise to an excess benefit.

Restrictions: Political Activities & Lobbying

PROHIBITION ON POLITICAL ACTIVITIES

- Section 501(c)(3) organizations are strictly prohibited from directly or indirectly participating in, or intervening in, any political campaign on behalf of (or in opposition to) any candidate for elective public office
- Contributions to political campaign funds or public statements of position (verbal or written) made on behalf of the organization in favor of or in opposition to any candidate for public office clearly violate this prohibition
- Violating this prohibition may result in denial or revocation of tax-exempt status and the imposition of certain excise taxes

LOBBYING: SUBSTANTIAL PART

- May not attempt to influence legislation as a substantial part of activities
- Where the nonprofit contacts, or urges the public to contact, members of a legislative body to propose, support, or oppose legislation, or if the organization advocates the adoption or rejection of legislation
- IRS decides if the activity constitutes a “substantial part” based on the facts and circumstances
- May lose tax-exempt status and be subject to an excise tax of 5% of the lobbying expenditures (against the organization and its managers!)

LOBBYING: EXPENDITURE TEST

- May elect the expenditure test under Section 501(h) as an alternative method for measuring lobbying
- Bright line amount an organization can spend without jeopardizing tax exempt status
- Limit is generally based upon the size of the organization and may not exceed \$1M
- Excise tax equal to 25% of the excess if noncompliant in a given year
- Can lose tax exempt status if the limit is exceeded over a four-year period
- Complete Form 5768 at anytime during the tax year

Measuring Lobbying Activity: The Expenditure Test

If the amount of exempt purpose expenditures is:	Lobbying nontaxable amount is:
≤ \$500,000	20% of the exempt purpose expenditures
>\$500,00 but ≤ \$1,000,000	\$100,000 plus 15% of the excess of exempt purpose expenditures over \$500,000
> \$1,000,000 but ≤ \$1,500,000	\$175,000 plus 10% of the excess of exempt purpose expenditures over \$1,000,000
>\$1,500,000 but ≤ \$17,000,000	\$225,000 plus 5% of the exempt purpose expenditures over \$1,500,000
>\$17,000,000	\$1,000,000

Unrelated Business Taxable Income (UBTI)

ELEMENTS OF UBTI

Tax-exempt organizations may owe taxes on income (UBTI) at corporate tax rates, if they:

1

Carry on a trade or business

2

that is regularly carried on, and

3

is not substantially related to the organization's exempt purpose

EXCEPTIONS AND EXCLUSIONS

- Most passive investment income (*e.g.*, dividends, interest from an unrelated borrower and gains from the sale or exchange of capital assets) and royalties are not UBTI and will be exempt from tax.
- The following activities are also specifically excluded:
 - Business where work is performed without compensation (volunteer bake sale)
 - Business carried on for the convenience of students, patients, employees (school cafeteria)
 - Business consisting of sale of donated merchandise (thrift shop)
- If the organization uses debt to fund any investment assets, the income from those assets could be treated as UBTI.

CLE COURSE CODE

2. Applying for Federal Tax-Exempt Status

How to Apply for Tax-Exempt Status



- Obtain an Employer Identification Number at www.irs.gov.
- There is no fee for this.



- Prepare an application for tax-exempt status using either:
- Form 1023-EZ: <https://www.irs.gov/forms-pubs/about-form-1023-ez>
- Form 1023: <https://www.irs.gov/forms-pubs/about-form-1023>

FORM 1023-EZ (\$275)

- Shorter form available to smaller organizations.
- To be eligible for Form 1023-EZ:
 - Projected annual gross receipts must not exceed \$50,000 in any of the next 3 years (reasonable basis);
 - Actual annual gross receipts must not have exceeded \$50,000 in any of the past 3 years; and
 - Total assets must not exceed \$250,000.
- Typically, takes 2-4 months to process

FORM 1023 (\$600)

- Detailed questionnaire that requires a narrative description of anticipated activities and financial projections for several years
- Typically, takes 6-9 months to process
- ***If you receive exemption under Form 1023-EZ and then exceed \$50K in revenues, you do not need to reapply using Form 1023!***

Both forms are filed electronically at <https://www.pay.gov/public/home>.

Anatomy of Form 1023

PART I	Identification of Applicant
PART II	Organizational Structure
PART III	Required Provisions
PART IV	Your Activities (Narrative Description)
PART V	Compensation and Other Financial Arrangements
PART VI	Financial Data
PART VII	Foundation Classification
PART VIII	Effective Date
PART IX	Annual Filing Requirements
PART X	Signature
SCHEDULES	As applicable

Anatomy of Form 1023: Key Parts

Part III: Required Provisions – Governance Practices

- Include copies of your governing documents: Articles of Incorporation, Certificate of Filing, Bylaws
- Disclose the location of the purpose clause and dissolution provisions in your Articles of Incorporation

Part IV: Your Activities – The Narrative Statement

- Requests a description of the nonprofit's past, present and planned activities in a narrative form
- Specific questions include: What is the activity? Who conducts the activity? Where is the activity conducted? What percentage of the organization's total time is allocated to the activity? How is the activity funded? How does the activity further your exempt purposes?

Part IV: Your Activities – Intellectual Property

- Must disclose whether the nonprofit will publish, own, or have rights in music, literature, tapes, artworks, choreography, scientific discoveries, or other intellectual property, including copyrights, patents, or trademarks?

Part IV: Your Activities – International Activities

- Requests details on any grant-making activities to foreign individuals or entities
- If so, includes a question about OFAC compliance

Anatomy of Form 1023: Key Parts

Part V: Compensation Arrangements

- Must include the names, titles, mailing address and compensation details for certain officers, directors and trustees
- Must disclose any relationships between officers, directors, trustees, highest compensated employees/independent contractors, and other organizations to make sure the nonprofit is operated for a public purpose and not for the private benefit of the members, individuals or another organization
- Include a copy of the conflict of interest policy (recommended but not required by the IRS)

Part VI: Financial Projections

- Requests both a current balance sheet (as of the fiscal year end) and income statements for three years (either projections or historical, depending on how long the entity has been in existence)
- Very important that the numbers “add up” and are consistent with the descriptions in the Narrative

Pay.gov

- Must submit everything online at [pay.gov](https://www.pay.gov)
- Create a single PDF file that you upload at the end of the application (not exceeding 15MB)

When to Apply for Tax-Exempt Status

27-MONTH RULE

Your organization must apply for tax-exempt status *within 27 months from the end of the month in which it was formed* in order to be recognized as tax-exempt *as of formation*.

If your organization applies for tax-exempt status after the 27-month deadline, exempt status may only be recognized *as of the date the application was filed*.

WHILE YOUR APPLICATION IS PENDING

ANNUAL TAX RETURNS

- Your organization must file an annual tax return with the IRS, using the appropriate IRS Form 990, even while its application for tax-exempt status is pending.

DONATIONS RECEIVED

- Donors will not have advance assurance that their donations are tax deductible while your organization's exemption is pending.
- If your organization ultimately qualifies for exemption for the period in which the contribution is made, the contribution will be tax-deductible by the donor. However, if the organization ultimately does not qualify for exemption, then the contribution will not be tax deductible.

Local Tax Exemptions in D.C.

D.C. TAX EXEMPTION

- While Section 501(c)(3) organizations are generally exempt from having to pay local taxes, tax-exemption in D.C. is not automatic.
- In order to be exempt from tax in D.C., the organization must file for exemption:
 - File Form 500: New Business Registration
 - File Form FR-164: Application for Exemption with the Office of Tax and Revenue, Exempt Organizations (covers exemption from D.C. income and franchise tax, sales and use tax, and personal property tax
 - File online at mytax.dc.gov
- To qualify for personal property tax exemption or sales tax exemption, the organization must be “semipublic”: any corporation, and any community chest, fund or foundation, organized exclusively for religious, scientific, charitable, or educational purposes, including hospitals, no part of the net earnings of which inures to the benefit of any private shareholder or individual
- Exempt organization are still required to collect D.C. sales tax when they sell tangible personal property in D.C.

Key Federal Filings

Each year, there are federal filing obligations your nonprofit may need to satisfy.

FEDERAL TAX RETURNS

- Tax-exempt organizations must file annual tax returns with the IRS, using an IRS Form 990.
 - There are different versions of the Form 990 (all available at <https://www.irs.gov/charities-non-profits/annual-exempt-organization-returns-notices-and-schedules>).
 - The appropriate form for your organization generally will depend on its gross receipts and assets.
- Your organization's annual Form 990s will be publicly available, and the general public and donors may rely on information contained therein.
- Failure to file for 3 years in a row will result in the revocation of tax-exempt status.

Which Form 990 is right for my organization?

- Form 990-N: Gross receipts normally less than or equal to \$50k
- Form 990-EZ: Gross receipts normally less than \$200k + total assets less than \$500k
- Form 990: Gross receipts greater than or equal to \$200k + total assets greater than or equal to \$500k
- Form 990-PF: Required for private foundations (regardless of financial status)

3. Exploring Nonprofit Best Practices

Best Practices: Key State Filings

There are also state and local filing obligations your nonprofit may need to satisfy.

D.C. FILINGS

- In order to legally solicit contributions in D.C., you must receive a basic business license (BBL) for the charitable solicitation category.
 - \$412.50 application fee for a two year license that must be renewed every two years.
 - Must already be incorporated, be classified as tax-exempt by the IRS, completed tax registration in D.C., and obtained a Certificate of Occupancy or Home Occupation Permit for physical premises.
 - The application fee is waived for organizations that have not and do not expect to receive more than \$25,000 in annual gross contributions.
 - Organizations that solicit solely from their own members, engage solely in workplace giving campaigns, and religious organizations that solicit solely for educational or religious purposes are exempt from licensure.
- The DCRA Two-Year Report is due April 1 (of the year after incorporation) and every two years thereafter.

OTHER STATES

- Most states require organizations to register with the state before soliciting donations from individuals, foundations or businesses located in the state.
- This includes Virginia and Maryland, in which most D.C. nonprofits should be licensed.
- There are exemptions, including for small, religious organizations, etc.
- Forty jurisdictions, including D.C., VA and MD, accept the Unified Registration Statement, in lieu of the state-specific form.
- Active online solicitation, e.g., through email, is subject to the same rules as solicitation through the U.S. mail.

Best Practices: Public Inspection

Public Inspection

Nonprofits must make the following documents available for public inspection at their offices upon in-person request and upon mail/email request:

- Their last three annual Forms 990/990-EZ, including schedules and attachments, and 990-Ts (if applicable)
- Their original IRS application for exemption (Form 1023/Form 1023-EZ)
- Their IRS exempt status determination letter

Public Availability/Copying Obligation

Nonprofits are also required to make copies of these documents available to the public.

Documents that are posted publicly online (*e.g.*, IRS website, GuideStar) satisfy this requirement

Documents that are not online must be provided in hard copy upon request (nonprofit can charge the requester copying and postage).

Compliance

Many nonprofits are unaware of these public inspection requirements and have not trained their directors/staff accordingly.

Failure to comply can trigger daily IRS fines.

If a nonprofit cannot find a copy of its Form 990 or 1023 exemption application, it can request a copy from the IRS using Form 4506-A.

Additional Resources

D.C. Bar Pro Bono Center: Contact

- Darryl Maxwell: dmaxwell@dcbar.org
- Jason Qu: jqu@dcbar.org

D.C. Bar: Help for Nonprofits

- <https://www.dcbar.org/pro-bono/free-legal-help/help-for-nonprofits>

Exponentum: Powering Business Law for Nonprofits (Lawyers Alliance)

- <https://lawyersalliance.org/exponentum>

IRS Publication 557: Tax-Exempt Status for your Organization

- <https://www.irs.gov/pub/irs-pdf/p557.pdf>

Bolder Advocacy: Enabling Nonprofit Advocacy

- <https://bolderadvocacy.org/>



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