

Starting and Representing a Nonprofit: Pro Bono Issues

Formation: Tax-Exemption

A. Internal Revenue Code Section 501(c)(3)

1. Exempt purposes. 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.
 - a. *Charitable*. The term charitable is used in section 501(c)(3) in its generally accepted legal sense and is, therefore, not to be construed as limited by the separate enumeration in section 501(c)(3) of other tax-exempt purposes which may fall within the broad outlines of charity as developed by judicial decisions. Such term includes: Relief of the poor and distressed or of the underprivileged; advancement of religion; advancement of education or science; erection or maintenance of public buildings, monuments, or works; lessening of the burdens of Government; and promotion of social welfare by organizations designed to accomplish any of the above purposes, or (i) to lessen neighborhood tensions; (ii) to eliminate prejudice and discrimination; (iii) to defend human and civil rights secured by law; or (iv) to combat community deterioration and juvenile delinquency.¹
 - b. *Educational*. 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.²

¹ Treas. Reg. §1.501(c)(3)-1(d)(2).

² Treas. Reg. §1.501(c)(3)-1(d)(3).

2. Organizational Test. The Organizational Test provides that a 501(c)(3) organization must be organized exclusively for one or more of the exempt purposes set forth in IRC Section 501(c)(3).³ This test is satisfied if the organization's governing documents meet certain requirements, including limitation of the organization's purpose, and dedication of its assets, to one or more exempt purposes.⁴
3. Operational Test. The Operational Test provides that a 501(c)(3) organization must be operated *primarily* for one or more of the exempt purposes set forth in IRC Section 501(c)(3).⁵ Only an "insubstantial part" of the organization's activities may be devoted to non-exempt purposes, such as operating an unrelated business.⁶ If, however, the organization's primary purpose is the operation of an unrelated trade or business, it may not qualify for 501(c)(3) exempt status, even if all of the profits from such trade or business are to be used in furtherance of its exempt purposes.
4. No Private Inurement. No part of the organization's net earnings may inure to the benefit of any private shareholder or individual. The private inurement doctrine generally prohibits an exempt organization from using its assets for the benefit of a person having a personal and private interest in the organization's activities (i.e., an insider such as a director, officer or key employee). An organization that engages in an inurement transaction (e.g., paying an unreasonable compensation to an insider) may face revocation of its exempt status.
5. No Private Benefit. An organization will similarly fail the Operational Test unless it serves a public rather than a private interest.⁷ To satisfy this requirement, referred to as the private benefit doctrine, the organization must establish that it is not operated for the benefit of private interests. This does not mean that the organization may not confer benefits to individuals; rather, it provides that such benefits must be incidental, quantitatively and qualitatively, to the furthering of the organization's exempt purposes.⁸ While the private benefit and private inurement doctrines appear very similar, there are two important differences. First, the private benefit doctrine is much broader than, and indeed subsumes, the private inurement doctrine because it applies whenever an impermissible benefit is being conferred on any private party, not just insiders. Second, unlike the case with private inurement, an incidental amount of private benefit may not cause a loss or denial of exempt status (see Excess Benefit Transactions below).

³ Treas. Reg. §1.501(c)(3)-1(a)(1).

⁴ Treas. Reg. §1.501(c)(3)-1(b).

⁵ Treas. Reg. §1.501(c)(2)-1(c)(1).

⁶ *See id.*

⁷ Treas. Reg. §1.501(c)(3)-1(d)(1)(ii).

⁸ Gen. Couns. Mem. 39862, Nov. 21, 1991.

6. Excess Benefit Transactions. Federal tax laws also prohibit certain transactions characterized by a conflict of interest. IRC Section 4958(c)(1)(A), which applies to organizations exempt under either IRC Section 501(c)(3) or 501(c)(4) that are not private foundations, defines an *excess benefit transaction* as “any transaction in which an economic benefit is provided by an applicable tax-exempt organization directly or indirectly to or for the use of any disqualified person⁹ if the value of the economic benefit provided exceeds the value of the consideration (including the performance of services) received for providing such benefit.” An excess benefit transaction involving a director is an example of self-dealing and a conflict of interest. Moreover, any excess benefit transaction is prohibited and may subject the disqualified person and the directors who knowingly approved such transaction to significant federal excise taxes (“intermediate sanctions”).¹⁰
7. No Substantial Lobbying. In general, no organization may qualify for Section 501(c)(3) status if a substantial part of its activities is attempting to influence legislation (commonly known as lobbying). A 501(c)(3) organization may engage in some lobbying, but too much lobbying activity risks loss of tax-exempt status. Legislation includes action by Congress, any state legislature, any local council, or similar governing body, with respect to acts, bills, resolutions, or similar items (such as legislative confirmation of appointive office), or by the public in referendum, ballot initiative, constitutional amendment, or similar procedure.¹¹ It does not include actions by executive, judicial, or administrative bodies. An organization will be regarded as attempting to influence legislation if it contacts, or urges the public to contact, members or employees of a legislative body for the purpose of proposing, supporting, or opposing legislation, or if the organization advocates the adoption or rejection of legislation.¹² Organizations may, however, involve themselves in issues of public policy without the activity being considered as lobbying. For example, organizations may conduct educational meetings, prepare and distribute educational materials, or otherwise consider public policy issues in an educational manner without jeopardizing their tax-exempt status.

Substantiality of lobbying activities is measured under one of two tests. Under the default substantial part test, little guidance is offered with respect to what activities are considered lobbying and how much lobbying is substantial. In one early case, devotion of less than 5% of an organization’s time and

⁹ A *disqualified person* with respect to a transaction is “(A) any person who was, at any time during the 5-year period ending on the date of such transaction, in a position to exercise substantial influence over the affairs of the organization [including directors of the corporation], (B) a member of the family of an individual described in subparagraph (A), (C) a 35-percent controlled entity....” IRC §4958(f)(1).

¹⁰ IRC §4958(a), (b).

¹¹ Treas. Reg. §1.501(c)(3)-1(c)(3)(ii).

¹² *Id.*

effort was found to be insubstantial. However, the test appears to have evolved with later cases and it generally is thought to consider all the facts and circumstances of an organization's lobbying activities (including cash expenditures, volunteer efforts and donated resources). Accordingly, charities must document all of their lobbying activities and expenses. If a charity engages in substantial lobbying in any one year, it may have its tax-exempt status revoked. Under the 501 (h) expenditure test, which may be elected by most public charities (churches being a significant exception), substantiality is measured only by the charity's total lobbying expenditures and grass roots expenditures. Accordingly, an electing charity is not subject to limits on lobbying activities that do not require expenditures (e.g., unreimbursed lobbying by volunteers). If an electing charity exceeds either the total lobbying or grass roots expenditures limit in any one year, it must pay an excise lobbying expenditures tax equal to 25% of the excess. If an electing charity exceeds both limits in any one year, it must pay 25% of whichever excess is greater. An electing charity will be subject to revocation of its tax-exempt status if, over a four-year period, either its total lobbying or grassroots expenditures exceed the appropriate aggregated annual limit over the period by more than 50%.

8. No Electioneering. All Section 501(c)(3) organizations are absolutely prohibited from directly or indirectly participating in, or intervening in, any political campaign on behalf of (or in opposition to) any candidate for elective 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. Such violation may result in denial or revocation of tax-exempt status and the imposition of certain excise tax. Note, however, that certain activities or expenditures may not be prohibited depending on the facts and circumstances. For example, certain voter education activities (including the presentation of public forums and the publication of voter education guides) and certain other activities intended to encourage people to participate in the electoral process (e.g., voter registration and get-out-the-vote drives), if conducted in a non-partisan manner, do not constitute prohibited political campaign activity.
9. Unrelated Business Activities. The general definition of unrelated business income (UBI) is income from a trade or business that is regularly carried on and is not substantially related to the organization's exempt purposes.¹³ A "trade or business" is an activity carried on for the production of income from the sale of goods or performance of services.¹⁴ Business activities are "regularly carried on" if they show a frequency and continuity and are pursued in a manner similar to comparable commercial activities of nonexempt

¹³ See IRC §512(a)(1).

¹⁴ Treas. Reg. §1.513-1(b).

organizations.¹⁵ An activity is "not substantially related" if it does not contribute importantly to the accomplishment of the organization's exempt purposes¹⁶ (see organization's governing documents and exemption application). Expending revenues generated from an activity in furtherance of exempt-related purposes does not make the activity itself substantially related. While related business income is not taxed, unrelated business taxable income (gross UBI less the deductions directly connected with carrying on the trade or business) is subject to corporate income taxes. UBI is reported on Form 990-T, which a charity must file if it has gross UBI of \$1,000 or more

The Internal Revenue Code contains a number of modifications, exclusions, and exceptions to unrelated business income. For example, dividends, interest, certain other investment income, royalties, certain rental income, certain income from research activities, and gains or losses from the disposition of property are excluded when computing unrelated business income.¹⁷ In addition, the following activities are specifically excluded from the definition of unrelated trade or business:

- a. *Volunteer Labor*: Any trade or business is excluded in which substantially all the work is performed for the organization without compensation.¹⁸ Some fundraising activities, such as volunteer operated bake sales, may meet this exception.
- b. *Convenience of Members*: Any trade or business is excluded that is carried on by an organization described in section 501(c)(3) or by a governmental college or university primarily for the convenience of its members, students, patients, officers, or employees.¹⁹ A typical example of this is a school cafeteria.
- c. *Selling Donated Merchandise*: Any trade or business is excluded that consists of selling merchandise, substantially all of which the organization received as gifts or contributions.²⁰ Many thrift shop operations of exempt organizations would meet this exception.

B. Form 1023 – Application for Recognition of Exemption Under §501(c)(3)

1. Insider Transactions. Among the disclosures required by the Form 1023 are details about the compensation paid, or to be paid, by the applicant to trustees,

¹⁵ Treas. Reg. §1.513-1(c).

¹⁶ Treas. Reg. §1.513-1(d).

¹⁷ IRC §512(b).

¹⁸ IRC §513(a)(1).

¹⁹ IRC §513(a)(2).

²⁰ IRC §513(a)(3).

directors, officers, five highest compensated employees (>\$50,000 per year), and five highest compensated independent contractors (>\$50,000 per year), including the practices used to set such compensation. In addition, the Form asks about relationships among insiders and business transactions between the applicant and insiders or entities related to insiders.

2. Conflict of Interest Policy. The Form 1023 asks: “Have you adopted a conflict of interest policy consistent with the sample conflict of interest policy in Appendix A to the instructions?” While an applicant is not required to answer “Yes” in order to qualify for exemption, it will have to describe what procedures it will follow to assure that persons who have a conflict of interest will not have influence over the applicant regarding their own compensation or business deals with themselves. Regardless of whether it is required, a conflict of interest policy is strongly recommended to help avoid prohibited self-dealing transactions and excess benefit transactions.
3. Narrative of Activities. Perhaps the most critical part of the Form 1023 is the narrative description of the applicant’s past, present, and planned activities. The instructions require a complete and detailed description for each activity that answers the following questions:
 - a. What is the activity?
 - b. Who conducts the activity?
 - c. When is the activity conducted?
 - d. Where is the activity conducted?
 - e. How does the activity further your exempt purposes?
 - f. What percentage of total time is allocated to the activity?
 - g. How is the activity funded?
 - h. What are the alternate names under which you operate?
4. 501(h) Election. Form 5768 may be filed by eligible organizations with their Form 1023 to make the 501(h) election (see No Substantial Lobbying section above). Under this election, the following lobbying expenditure limits apply:

Total Lobbying Expenditures (direct and grassroots):

- a. 20% of the first \$500,000 of Exempt Purpose Expenditures +
- b. 15% of the next \$500,000 of Exempt Purpose Expenditures +
- c. 10% of the next \$500,000 Exempt Purpose Expenditures +
- d. 5% of the remaining Exempt Purpose Expenditures,
up to a total lobbying expenditure cap of \$1 million.

Grassroots Lobbying: 25% of the Total Lobbying Expenditures Limits.

5. **Waiting Time.** IRS Exempt Organization Determination Application Process: Upon receipt, exemption applications accompanied by the required user fee are initially separated into four categories: (1) those that can be approved immediately based on the information submitted, (2) those that need minor additional information to be resolved, (3) those that are submitted on obsolete forms or do not include the items specified on the Procedural Checklist (attached to Form 1023), and (4) those that require development. If your application falls within one of the first three categories, you will receive either your determination letter or a request for additional information, via phone, fax, or letter, within approximately 90 days of the date the application was submitted. If your application falls within the fourth category, you will be contacted once the application is assigned to an EO agent for further development. Because these applications may experience some “wait time” before they are assigned, we regularly publish the receipt date for applications currently being assigned, to help you track your application (see IRS webpage – “Where is My Exemption Application?”).

C. Public Charities vs. Private Foundations

Organizations described in Section 501(c)(3) fall into two categories: private foundations and public charities. Under Section 509, all organizations, domestic or foreign, described in Section 501(c)(3) are private foundations except the types of organizations described in Sections 509(a)(1), (2), (3) or (4). "Public charities" is the generic term given to the excepted organizations.

The distinction between private foundation and public charity classification is critical because public charity status is by far the more advantageous category where there is a choice for a number of reasons.

Private foundations are subject to additional regulation and must:

- Refrain from acts of self-dealing (Section 4941).²¹
- Meet minimum distribution requirements (Section 4942).²²

²¹ Section 4941 imposes a tax on a *disqualified person* and on foundation managers that participate in an act of self-dealing, knowing that it is such an act. A “disqualified person” under the private foundation laws is defined differently from its definition under Section 4958 (excess benefit transactions applicable to public charities). Section 4946(a) defines a “disqualified person” to include: (A) a substantial contributor to the foundation; (B) a foundation manager; (C) a 20-percent owner of an entity which is a substantial contributor; (D) a member of the family of any individual described in (A), (B), or (C); (E) a 35-percent controlled entity (an entity in which persons described in (A), (B), (C), or (D) own more than 35 percent of the total controlled voting power (corporations), profits interest (partnerships) or beneficial interest (trusts and estates). A “substantial contributor” for this purpose means any person who contributed or bequeathed an aggregate amount of more than \$5,000 to the private foundation, if such amount is more than 2 percent of the total contributions and bequests received by the foundation before the close of the taxable year of the foundation in which the contribution or bequest is received by the foundation from such person. In the case of a trust, the term “substantial contributor” also means the creator of the trust.

- Abstain from "excess business holdings" (Section 4943).²³
- Abstain from "jeopardizing investments" (Section 4944).²⁴
- Refrain from making certain expenditures (Section 4945).²⁵

Additional advantages flowing from public charity classification involve:

- Exemption from Section 4940 tax on net investment income to which most private foundations are subject.²⁶
- Less burdensome reporting requirements (the annual information return that most private foundations must complete, Form 990-PF, is more complex than the information returns filed by public charities (Forms 990 and Form 990-EZ).
- Exemption, in the case of certain public charities, from various federal excise taxes.
- Additional fundraising opportunities due to several factors:
 - Higher dollar limitations apply to contributions made by individuals and corporations to public charities.
 - Under Section 642(c), organizations classified under Section 509(a)(1) (i.e., public charities) may establish and maintain pooled income funds; other organizations described in Section 501(c)(3) may not.
 - The expenditure responsibility rules of Section 4945(d)(4) make it far more likely that a public charity will receive grants from private foundations.

Public Charities:

Section 509(a)(1) Public Charity: an organization described in section 170(b)(1)(A) (other than in clauses (vii) and (viii)):

- (i) Churches or conventions or associates of churches,
- (ii) Certain educational organizations,
- (iii) Hospital and medical research organizations,
- (iv) Endowment funds organized and operated in connection with state and municipal colleges and universities,
- (v) Governmental unit,
- (vi) Publicly supported organizations described in Section 170(c)(2) that normally receive a substantial part of their support (exclusive of income received in the exercise of

²² Section 4942 generally provides for a 5% distribution requirement of the distributable amount, which is based on the fair market value of the noncharitable use assets (e.g., the endowment).

²³ Section 4943 generally prohibits a private foundation and its disqualified persons from collectively owning more than 20% of voting stock of an entity (or 35% where a non-disqualified person has effective control of such entity) in which the private foundation owns at least 2% of such entity's voting stock.

²⁴ An investment is jeopardized if the officers or directors failed to exercise ordinary care and prudence when the investment was made.

²⁵ Section 4945 imposes a tax on certain taxable expenditures such as those paid or incurred to lobby, electioneer, make grants to individuals that do not satisfy certain criteria, and make grants to organizations other than those described by Section 509(a)(1), (2) or (3) or operating foundations if the private foundation does not exercise expenditure responsibility.

²⁶ Section 4940(a) imposes a 2% tax on a private foundation's net investment income.

its exempt purpose or function) from a governmental unit or from direct or indirect contributions from the general public. The "substantial part of support" requirement is met by satisfying either (1) the "One-Third Support Test," or (2) the "Facts and Circumstances" test. The percentages are calculated by using total support as the denominator and public support as the numerator. Both tests generally measure an organization's public support over a five-year period including the year being tested and the preceding four years. Support (revenues) is counted using the same accounting method (e.g., cash, accrual) as used in keeping the organization's books and preparing its annual Form 990 information return.

One-Third Support Test (170(b)(1)(A)(vi)):

An organization will qualify as public supported if it normally receives at least one-third of its TOTAL SUPPORT from sources that qualify as PUBLIC SUPPORT.

$$\frac{\text{PUBLIC SUPPORT}}{\text{TOTAL SUPPORT}} = 1/3 \text{ or greater}$$

An organization will be considered as normally meeting the One-Third Support Test for its current tax year and the next tax year if, over a 5-year period ending on and including the current tax year (the "5 Year Measuring Period"), the organization meets the One-Third Support Test on an aggregate basis.

SUPPORT includes:

- Gifts, grants²⁷, contributions or membership fees.
- Net income from unrelated business activities, whether or not those activities are carried on regularly as a trade or business.
- Gross investment income.
- Tax revenues levied for the benefit of an organization and either paid to or spent on behalf of the organization.
- The value of services and facilities furnished by a governmental unit to an organization without charge (except services or facilities generally furnished to the public without charge).

Generally, SUPPORT does not include:

- Gains from the sale of capital assets.
- Any amount received from the exercise or performance by an organization of the purpose or function constituting the basis for its exemption (in general, these amounts include amounts received from any activity the conduct of which is substantially related to the furtherance of the exempt purpose or function, other than through the production of income).

²⁷ An "unusual grant," as described in Treasury Regulation 1.170A-9(e)(6), may be excluded from both support tests.

- Contributions of services for which a deduction is not allowed.

PUBLIC SUPPORT includes:

- Direct or indirect contributions from the general public, including contributions from an individual, trust or corporation, but only to the extent that the total contributions from such individual, trust or corporation, during the 5-Year Measuring Period, are not more than 2% of the organization's TOTAL SUPPORT for the same period. For example:
 - ORG has TOTAL SUPPORT of \$800,000.
 - ORG receives a contribution from Donor of \$200,000.
 - \$200,000 = part of ORG's TOTAL SUPPORT (now \$1 million).
 - Only \$20,000 (2% of TOTAL SUPPORT) = ORG's PUBLIC SUPPORT.
- SUPPORT received from governmental units.*
- Contributions from other publicly-supported charities.*

* Contributions from a governmental unit or from a publicly-supported organization are not subject to the 2% limit unless the contributions represent amounts earmarked by a donor to the governmental unit or publicly-supported organization as being for, or for the benefit of, the particular organization claiming a publicly-supported status.

Facts and Circumstances Test (170(b)(1)(A)(vi)):

The Facts and Circumstances Test is for organizations failing to meet the One-Third Support Test. If an organization fails to meet the One-Third Support Test, it may still be treated as a publicly-supported organization if it normally receives a substantial part of its support from governmental units, from direct or indirect contributions from the general public, or from a combination of these sources.

An organization will normally meet the requirements of the Facts and Circumstances Test for its current year and the next tax year if, for the 5-Year Measuring Period, the organization meets the Ten-Percent-of-Support Requirement and the Attraction of Public Support Requirement on an aggregate basis and satisfies a sufficient combination of the Five Public Support Factors discussed later.

Note that the fact that an organization has normally met the One-Third Support Test requirements for a current tax year, but is unable to meet the requirements for a later tax year, will not in itself prevent the organization from meeting the requirements of the Facts and Circumstances Test for the later tax year.

Ten-Percent-of-Support Requirement:

The Ten-Percent Support Test is based on the same ratio described in the One-Third Support Test, only with a lower threshold. An organization must normally receive PUBLIC SUPPORT equal to at least 10% of its TOTAL SUPPORT for PUBLIC SUPPORT to be considered sufficiently substantial to meet the public support requirement.

Attraction of Public Support Requirement:

An organization must be organized and operated in a manner to attract new and additional public or governmental support on a continuous basis. An organization will meet this requirement if (i) it maintains a continuous and bona fide program for solicitation of funds from the general public, community, or membership group involved; or (ii) it carries on activities designed to attract support from governmental units or other charitable organizations described in IRC 509(a)(1). In determining whether an organization maintains a continuous and bona fide program for solicitation of funds from the general public or community, consideration will be given to whether the scope of its fundraising activities is reasonable in light of its charitable activities. Consideration also will be given to the fact that an organization may, in its early years of existence, limit the scope of its solicitation to persons who would be most likely to provide seed money sufficient to enable it to begin its charitable activities and expand its solicitation program.

Five Public Support Factors:

1. *Percentage of financial support factor.* The greater the PUBLIC SUPPORT/TOTAL SUPPORT ratio, the lesser the burden of establishing the publicly supported nature of the organization through other factors, and vice versa. If the ratio is low because the organization receives a high percentage of its TOTAL SUPPORT from investment income on its endowment funds, the organization will be treated as complying with this factor if the endowment fund was originally contributed by a governmental unit or by the general public. However, if the endowment funds were originally contributed by a few individuals or members of their families, this fact will increase the burden on the organization of establishing compliance with other factors. Facts pertinent to years before the 4 tax years immediately before the current tax year also may be considered.

2. *Sources of support factor.* The fact that an organization receives its PUBLIC SUPPORT from governmental units or directly or indirectly from a representative number of persons, rather than receiving almost all of its support from the members of a single family, will be considered in determining whether the organization is publicly supported. In determining whether what is a representative number of persons, consideration will be given to the type of organization involved, the length of time it has existed, and whether it limits its activities to a particular community or region or to a special field that can be expected to appeal to a limited number of persons. Facts pertinent to years before the measuring period may also be considered.

3. *Representative governing body factor.* The fact that an organization has a governing body that represents the broad interests of the public rather than the personal or private interest of a limited number of donors will be considered in determining whether the organization is publicly supported. An organization will meet this requirement if it has a governing body composed of: (a) public officials acting in their public capacity; (b) individuals selected by public officials acting in their public capacities; (c) persons having special knowledge or expertise in the particular field or discipline in which the organization is operating; and (d) community leaders, such as elected or appointed officials, members of the clergy, educators, civil leaders, or other such persons representing a broad cross-section of the views and interests of the community.

4. *Availability of public facilities or services factor.* The fact that an organization generally provides facilities or services directly for the benefit of the general public on a continuing basis is evidence that the organization is publicly supported. Examples are: (a) a museum or library that is open to the public; (b) a symphony orchestra that gives public performances; (c) a conservation organization that provides educational services to the public through the distribution of educational materials; (d) an old-age home that provides domiciliary or nursing services for members of the general public. The following factors also evidence that an organization is publicly supported: (a) participating in, or sponsoring of, the programs of the organization by members of the public having special knowledge or expertise, public officials, or civil or community leaders; (b) maintaining a definitive program by the organization to accomplish its charitable work in the community, such as slum clearance or developing employment opportunities; (c) receiving a significant part of its funds from a public charity or governmental agency to which it is in some way held accountable as a condition of the grant, contract or contribution.

5. *Additional factors pertinent to membership organizations.*

- (a) Whether the solicitation for dues-paying members is designed to enroll a substantial number of persons in the community or area, or in a particular profession or field of special interest (taking into account the size of the area and the nature of the organization's activities).
- (b) Whether membership dues for individual (rather than institutional) members have been fixed at rates designed to make membership available to a broad cross section of the interested public, rather than to restrict membership to a limited number of persons.
- (c) Whether the activities of the organization will be likely to appeal to persons having some broad common interest or purpose, such as educational activities in the case of alumni associations, musical activities in the case of symphony societies, or civil affairs in the case of parent-teacher associations.

Section 509(a)(2) Public Charity: a publicly supported organization for which its public support more typically consists of gross receipts derived from an activity that is related to its exempt function (e.g., sales receipts). An organization will be excluded from private foundation status under Section 509(a)(2) if it meets both (i) the One-Third Support Test under Section 509(a)(2)(A)²⁸; and (ii) the Not-More-Than-One-Third Support Test under Section 509(a)(2)(B).

One-Third Support Test (509(a)(2)(A)):

An organization will meet this One-Third Support Test if it normally receives at least one-third of its TOTAL SUPPORT from sources that qualify as “PUBLIC SUPPORT.”

$$\frac{\text{PUBLIC SUPPORT}}{\text{TOTAL SUPPORT}} = 1/3 \text{ or greater}$$

An organization will be considered as normally meeting the One-Third Support Test for its current tax year and the next tax year if, for the 5-Year Measuring Period, the organization meets the One-Third Support Test on an aggregate basis.

SUPPORT includes:

- Gifts, grants²⁹, contributions or membership fees.
- Any amount received from the exercise or performance by an organization of the purpose or function constituting the basis for its exemption (in general, these amounts include amounts received from any activity the conduct of which is substantially related to the furtherance of the exempt purpose or function, other than through the production of income).
- Net income from unrelated business activities, whether or not those activities are carried on regularly as a trade or business.
- Gross investment income (other than gains from the sale of capital assets).
- Tax revenues levied for the benefit of an organization and either paid to or spent on behalf of the organization.
- The value of services and facilities furnished by a governmental unit to an organization without charge (except services or facilities generally furnished to the public without charge).

PUBLIC SUPPORT includes:

- Gifts, grants, contributions or membership fees from permitted sources (governmental units, Section 509(a)(1) public charities and persons other than disqualified persons).

²⁸ Note that the One-Third Support Test under Section 509(a)(2) is different from the One-Third Support Test under Section 170(b)(1)(A)(vi).

²⁹ An “unusual grant,” as described in Treasury Regulation 1.170A-9(e)(6), may be excluded from both support tests.

- Gross receipts from admissions, sales of merchandise, performance of services, or furnishing of facilities, in an activity which is not an unrelated trade or business, from permitted sources, *subject to the following limitation*: gross receipts from related activities received from any person, or from any bureau or similar agency of a governmental unit, are includible in any taxable year only to the extent that such receipts do not exceed the greater of \$5,000 or 1 percent of the organization's total support in such taxable year.

Not-More-Than-One-Third Support Test (509(a)(2)(B)):

An organization will meet the Not-More-Than-One-Third Support Test if it normally receives not more than one-third of its total support from the following sources:

- Net income from unrelated business activities, whether or not those activities are carried on regularly as a trade or business.
- Gross investment income (other than gains from the sale of capital assets).

An organization will be considered as normally meeting the Not-More-Than-One-Third Support Test for its current tax year and the next tax year if, for the 5-Year Measuring Period, the organization meets the Not-More-Than-One-Third Support Test on an aggregate basis.

Section 509(a)(3) Public Charity: *a supporting organization* that meets all of the following tests:

(A) Organizational and Operational Tests. The organization must be organized and at all times operated for the benefit of, and to perform the function of, the specified organizations described in Sections 509(a)(1) and (2).

(B) Nature of Relationship Test. The organization must be operated, supervised, or controlled by, or in connection with, one or more organizations described in Sections 509(a)(1) and (2).

(C) Lack of Outside Control Test. The organization must not be controlled directly or indirectly by one or more disqualified persons other than foundation managers and other than one or more organizations described in Sections 509(a)(1) or (2).

According to the IRS:

Supporting organizations are charities that carry out their exempt purposes by supporting other exempt organizations, usually other public charities. The classification is important because it is one means by which a charity can avoid classification as a private foundation, a status that is subject to a much more restrictive regulatory regime. The key feature of a supporting organization is a strong relationship with an organization it supports. The strong relationship

enables the supported organization to oversee the operations of the supporting organization. Therefore, the supporting organization is classified as a public charity, even though it may be funded by a small number of persons in a manner similar to a private foundation.

Examples: University endowment funds and organizations that provide essential services for hospital systems.

Like all charitable organizations, a supporting organization must be organized and operated exclusively for purposes described in section 501(c)(3). A supporting organization must also be organized and operated exclusively to support specified supported organizations. Moreover, a supporting organization must have one of three relationships with the supported organizations, all of which are intended to ensure that the supporting organization is responsive to the needs or demands of the supported organization and intimately involved in its operations and that the public charity is motivated to be attentive to the operations of the supporting organization. Type I supporting organizations are *operated, supervised, or controlled by* the supported organization. Type II supporting organizations are *supervised or controlled in connection with* the supported organization. Type III supporting organizations are *operated in connection with* the supported organization. Because Type III relationships are less formal than a Type I or Type II relationship, Type III organizations must meet a *responsiveness* test and an *integral part* test. These tests are designed to ensure that the supporting organization is responsive to needs of a public charity and that the public charity oversees the operations of the supporting organization. Finally, the supporting organization must not be controlled directly or indirectly by disqualified persons.

Some promoters have encouraged individuals to establish and operate supporting organizations described in section 509(a)(3) for their own benefit. A common theme of such abusive transactions is a *charitable* donation of an amount to the supporting organization, and a return of the donated amounts to the donor, often in the form of a loan. To disguise the abuse, the transaction may be routed through more intermediary organizations controlled by the promoter. Because of these abuses, Congress imposes additional restrictions on certain supporting organizations.

Organizations that operate for the personal benefit of their founders are not operated exclusively for purposes described in section 501(c)(3). Where part of an organization's net earnings inures to the benefit of private persons or where more than an insubstantial part of its activities benefits private interests, the organization will fail to qualify. In addition, excise taxes may be imposed on its disqualified persons and organization managers. Even where the

organization does not operate for the personal benefit of its founder, it may not qualify for section 509(a)(3) classification because -

- It is controlled by disqualified persons.
- It is not sufficiently responsive to the needs or demands of a supported public charity.
- It does not maintain a significant involvement in the affairs of a specified publicly supported charity.
- A specified public charity might not be motivated to be attentive to its operations.

Loss of section 509(a)(3) classification means that the organization would be classified as a private foundation, subject to private foundation excise taxes.

Section 509(a)(4) Public Charity: an organization which is organized and operated exclusively for testing for public safety.

D. Franchise Tax Board – Form 3500 or Form 3500A

1. All corporations and unincorporated associations, even if organized on a nonprofit basis, are subject to California corporation franchise tax or income tax until the FTB grants tax-exempt status to the organization. Churches are not exempt from this rule.
2. California allows federally tax-exempt IRC Section 501(c)(3) organizations to be exempt from state income taxes after submitting Form 3500A, Submission of Exemption Request, and a copy of the IRS determination letter to the FTB.
3. The FTB may grant tax-exempt status retroactively for periods in which the organization substantiates that it was organized and operated for tax-exempt purposes under Revenue and Taxation Code §23701d (on its Form 3500). The FTB may consider the Form as a claim for refund if the organization is subsequently found to be tax-exempt during the same period that the organization previously paid tax. In no event shall a claim for refund be allowed unless timely filed under Revenue and Taxation Code §19306 – generally, after a period ending (i) four years from the date the return was timely filed, (ii) four years from the last day prescribed for filing the return (determined without regard to any filing extension), or (iii) after one year from the date of the overpayment, whichever period expires later.

This memorandum is intended to provide accurate information with respect to its subject matter. It does not constitute legal or professional advice, and it is not an invitation for an attorney-client relationship. If specific legal advice is sought, the reader is advised to retain the services of a competent professional.

Starting and Representing a Nonprofit: Pro Bono Issues

Miscellaneous

A. California Attorney General

1. Supervisory Powers. To ascertain the condition of its affairs and to what extent, if at all, it fails to comply with trusts which it has assumed or has departed from the purposes for which it is formed. In case of any such failure or departure the AG may institute the proceeding necessary to correct the noncompliance or departure. Corp. Code §5250.
2. Statute of Limitations. Any action brought by the AG against trustees or other persons holding property in trust for charitable purposes or against any charitable corporation or any director or officer thereof to enforce a charitable trust or to impress property with a trust for charitable purposes or to recover property or the proceeds thereof for and on behalf of any charitable trust or corporation, may be brought at any time within ten (10) years after the cause of action shall have accrued. Gov. Code §12596.
3. Registry of Charitable Trusts – Filings.
 - a. Initial Filing. Form CT-1. Due within 30 days of receipt of assets.
 - b. Annual Filings. Form RRF-1. Due 4 months and 15 days after end of tax year.
4. Charitable Trust Doctrine. The charitable trust doctrine requires that a gift accepted by a charitable corporation must only be used for the expressly declared charitable purposes of the donee corporation at the time of the acceptance, even if the corporation changes its purpose, transfers those assets or dissolves. Such restriction is imposed notwithstanding the fact that the donor did not expressly place any restrictions on the gift. Accordingly, if a charitable corporation amends its charitable purposes, gifts received pre-amendment may be used only to further the original charitable purposes. Pre-amendment gifts may not be used to further the new charitable purposes if such use is not in furtherance of the original charitable purposes.
 - a. The charitable trust doctrine may apply not only to gifts received by the charitable corporation but also to revenues generated by the corporation (e.g., earned income). The rationale for this expansive view of the doctrine is that (i) it may be impossible to separate out donations and contributions from other revenues, and (ii) such revenues may have only been derived from the "base capital" created by the donated assets.

- b. The expressly declared charitable purposes of a charitable corporation are first evidenced by its articles of incorporation and other formal manifestations of its declared purposes. *Pacific Home v. County of Los Angeles*, 41 Cal.2d 844 (1953). They may also be evidenced by oral and informal declarations of the corporation's charitable purposes. *Holt v. College of Osteopathic Physicians and Surgeons*, 61 Cal.2d 750 (1964). Moreover, such purposes may be deduced from the corporation's dominant activities and its representations to tax authorities and the public. *Queen of Angels Hospital v. Younger*, 66 Cal.App.3d. 359 (1977).
- c. The exception to the general rule of the charitable trust doctrine applies where the charitable purpose has become illegal, impossible or impracticable. In such case, the *cy pres* doctrine requires that the gift accepted to further the original charitable purpose be used to further a charitable purpose that is as near as possible to the original charitable purpose.

B. Maintaining the Nonprofit Corporation

1. Board Meeting Minutes. Each corporation shall keep minutes of the proceedings of its members, board and committees of the board. Corp. Code §6320. See <http://www.nonprofitlawblog.com/home/2011/02/board-meeting-minutes.html>.
 - a. Do's:
 - i. Record attendance, presence of quorum
 - ii. Record compliance (type of meeting, notice, etc.)
 - iii. Record actions and deliberations
 - iv. Record votes and abstentions
 - v. Evidence appropriate oversight
 - vi. Approve past meeting minutes
 - b. Don'ts:
 - i. Record transcript of everything said
 - ii. Record information that might be harmful
 1. Caution: employee accessibility to minutes
 2. Caution: voting member inspection rights
 - iii. Record attorney-client communications

2. Periodic Filings.

- a. Form 990 Series (IRS). Due the 15th day of 5th month after the end of the accounting year. Failure to file Form 990 for 3 consecutive years will lead to an automatic revocation of federal tax-exempt status. The following types of organizations, among others, are exempted from the filing requirements: churches, certain other religious organizations, certain governmental organizations, and certain political organizations.
 - i. Gross receipts normally \leq \$50,000 = Form 990-N
 - ii. Gross receipts $<$ \$200,000, and
Total assets $<$ \$500,000 = Form 990-EZ or 990
 - iii. Gross receipts \geq \$200,000, or
Total assets \geq \$500,000 = Form 990
 - iv. Private Foundations = Form 990-PF
- b. Form 199 Series (FTB). Due the 15th day of 5th month after the end of the accounting year. Failure to file Form 199 for 3 consecutive years will lead to an automatic revocation of state tax-exempt status. The following types of organizations, among others, are exempted from the filing requirements: churches, certain other religious organizations, and certain political organizations.
 - i. Gross receipts normally \leq \$25,000 = Form 199N
 - ii. Gross receipts $>$ \$25,000 = Form 199
 - iii. Private Foundations = Form 199
- c. Form RRF-1 (Registry of Charitable Trusts). Due the 15th day of 5th month after the end of the accounting year. Must include Form 990 or 990-EZ or 990-PF if gross revenue or assets \geq \$25,000. The following types of organizations, among others, are exempted from the registration requirements: religious organizations, educational institutions, and hospitals.
- d. Statement of Information – Nonprofit (Form SI-100) (Secretary of State). Due initially within 90 days after filing the initial Articles of Incorporation and every two years thereafter during the applicable filing period (the calendar month during which the initial Articles of Incorporation were filed and the immediately preceding five calendar months). Changes to information contained in a previously filed statement can be made by filing a new form, completed in its entirety. See <https://businessfilings.sos.ca.gov/>

This memorandum is intended to provide accurate information with respect to its subject matter. It does not constitute legal or professional advice, and it is not an invitation for an attorney-client relationship. If specific legal advice is sought, the reader is advised to retain the services of a competent professional.