

# **Section 501(c)(3) Organizations**

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## Section 501(c)(3) Organizations

### A. Section 501(c)(3) Organizations

Section 501(c)(3) organizations that are tax-exempt under Section 501(a) are defined as:

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.<sup>1</sup>

The Organizational Test. The organization must be organized exclusively for one or more of the exempt purposes set forth in Section 501(c)(3).<sup>2</sup> The Organization Test is satisfied if the organization's governing documents meet certain requirements, including limiting the organization's purpose and irrevocably dedicating its assets to one or more exempt purposes.<sup>3</sup>

The Operational Test. The organization must be operated exclusively for one or more of the exempt purposes set forth in Section 501(c)(3).<sup>4</sup> Notwithstanding the use of the word *exclusively*, the Operation Test is satisfied if the organization is operated *primarily* for such exempt purposes.<sup>5</sup> Only an "insubstantial part" of the organization's activities may be devoted to non-exempt purposes, such as operating an unrelated business.<sup>6</sup>

No Private Inurement. An organization will fail the Operational Test if any part of the organization's net earnings inure to the benefit of any private shareholder or individual.<sup>7</sup> 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).

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<sup>1</sup> IRC §501(c)(3).

<sup>2</sup> Treas. Reg. §1.501(c)(3)-1(a)(1).

<sup>3</sup> See Treas. Reg. §1.501(c)(3)-1(b).

<sup>4</sup> Treas. Reg. §1.501(c)(3)-1(a)(1).

<sup>5</sup> See Treas. Reg. §1.501(c)(3)-1(c).

<sup>6</sup> See *id.*

<sup>7</sup> Treas. Reg. §1.501(c)(3)-1(c)(2).

An organization that engages in an inurement transaction (e.g., paying an unreasonable compensation to an insider) may face revocation of its exempt status.

**No Private Benefit.** An organization will similarly fail the Operational Test unless it serves a public rather than a private interest.<sup>8</sup> 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.<sup>9</sup>

While the private benefit and private inurement doctrines appear very similar, there are two important differences. One, 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. Two, unlike the case with private inurement, an incidental amount of private benefit may not cause a loss or denial of exempt status. Instead, excise taxes, referred to as intermediate sanctions, may be imposed on *excess benefit transactions* between Section 501(c)(3) public charities and *disqualified persons*.<sup>10</sup> The IRS takes the position that it may both revoke an organization's exempt status and apply intermediate sanctions to the disqualified persons and any organizational managers who knowingly approved a prohibited private inurement transaction

**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. 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. Organizations may, however, involve themselves in issues of public policy without the activity being considered as lobbying. For example, organizations may conduct educational meetings,

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<sup>8</sup> Treas. Reg. §1.501(c)(3)-1(d)(1)(ii).

<sup>9</sup> G.C.M 39598 (January 23, 1987).

<sup>10</sup> IRC §4958. In this context, a *disqualified person* 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; (B) a member of the family of an individual described in (A), and (C) a 35-percent controlled entity (an entity in which persons described in (A) or (B) own more than 35 percent of the total controlled voting power (corporations), profits interest (partnerships) or beneficial interest (trusts and estates)). An *excess benefit transaction* is any transaction in which an economic benefit is provided by the applicable tax-exempt organization directly or indirectly to or for the use of any disqualified person, if the value of the economic benefit provided by the exempt organization exceeds the value of the consideration (including the performance of services) received for providing the benefit.

prepare and distribute educational materials, or otherwise consider public policy issues in an educational manner without jeopardizing their tax-exempt status.

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.

## **B. 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).<sup>11</sup>
- Meet minimum distribution requirements (Section 4942).<sup>12</sup>
- Abstain from "excess business holdings" (Section 4943).<sup>13</sup>
- Abstain from "jeopardizing investments" (Section 4944).<sup>14</sup>
- Refrain from making certain expenditures (Section 4945).<sup>15</sup>

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<sup>11</sup> 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.

<sup>12</sup> 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).

<sup>13</sup> 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.

<sup>14</sup> An investment is jeopardized if the officers or directors failed to exercise ordinary care and prudence when the investment was made.

<sup>15</sup> 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

Additional advantages flowing from public charity classification involve:

- Exemption from Section 4940 tax on net investment income to which most private foundations are subject.<sup>16</sup>
- 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 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 a "One-Third Support Test" or, alternatively, a "Facts and Circumstances" 10 percent 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 four-year period.

**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.

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

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other than those described by Section 509(a)(1), (2) or (3) or operating foundations if the private foundation does not exercise expenditure responsibility.

<sup>16</sup> Section 4940(a) imposes a 2% tax on a private foundation's net investment income.

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 4 tax years immediately before the current tax year, the organization meets the One-Third Support Test on an aggregate basis.<sup>17</sup>

SUPPORT includes:

- Gifts, grants<sup>18</sup>, 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).
- 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 4-year period immediately before the current tax year (or substituted computation 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.\*

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<sup>17</sup> For new organizations, there is a special computation period.

<sup>18</sup> An "unusual grant," as described in Treasury Regulation 1.170A-9(e)(6), may be excluded from both support tests.

\* 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 4 tax years immediately before the current tax year, 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.<sup>19</sup>

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

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<sup>19</sup> For new organizations, there is a special computation period.

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. 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)<sup>20</sup>; 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 4 tax years immediately before the current tax year, the organization meets the One-Third Support Test on an aggregate basis.<sup>21</sup>

SUPPORT includes:

- Gifts, grants<sup>22</sup>, contributions or membership fees.

<sup>20</sup> 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).

<sup>21</sup> For new organizations, there is a special computation period.

<sup>22</sup> An “unusual grant,” as described in Treasury Regulation 1.170A-9(e)(6), may be excluded from both support tests.

- 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).
- 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 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 4 tax years immediately before the current tax year, the organization meets the Not-More-Than-One-Third Support Test on an aggregate basis.<sup>23</sup>

**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

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<sup>23</sup> For new organizations, there is a special computation period.

organizations described in Sections 509(a)(1) and (2).<sup>24</sup>

(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).<sup>25</sup>

(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).<sup>26</sup>

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

*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.*

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<sup>24</sup> Treas. Reg. §1.509(a)-4(b).

<sup>25</sup> Treas. Reg. §1.509(a)-4(f).

<sup>26</sup> Treas. Reg. §1.509(a)-4(j).