



Lawyers Alliance  
*for* New York

*Connecting lawyers, nonprofits, and communities*

chapter 7

## **Applying for Federal Tax-Exempt Status**

*This insert replaces Chapter 7 of Getting Organized (Fifth Edition). It summarizes the requirements of the Internal Revenue Services Form 1023 (Rev. June 2006), which most organizations must submit for recognition of 501(c)(3) status.*

## A. THE APPLICATION PROCESS

As has already been noted, a not-for-profit organization will not be treated as exempt under Section 501(c)(3) of the Code, unless it obtains a determination of its tax-exempt status from the IRS.<sup>1</sup>

In order to obtain such a determination, the organization must file an application for exemption on Form 1023. For organizations seeking exemption under Sections 501(c)(4) (social welfare organizations), 501(c)(6) (business leagues) or 501(c)(7) (social clubs) of the Code, the appropriate form is Form 1024.<sup>2</sup>

There are no prescribed time limits for the filing of an exemption application. However, for organizations seeking exemption under Section 501(c)(3) of the Code, the time of filing determines whether exemption, if granted, will be retroactive to the date the organization was formed or only to the date of application.<sup>3</sup> An organization may apply for exemption retroactive to the date of organization if it applies within 27 months after the end of the month in which it was legally formed.<sup>4</sup> If an organization fails to apply within its first 27 months, it may still be granted exemption, but the exemption will be retroactive only to the date of the application.<sup>5</sup>

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<sup>1</sup> An exception is made for publicly supported organizations which meet the qualifications for Sec. 501(c)(3) of the Code and whose annual gross receipts are normally not more than \$5,000. I.R.C. Sec. 508(c)(1)(B). Treas. Reg. Sec. 1.508-1(a)(3)(b).

<sup>2</sup> Technically, the requirements for organizations seeking Sec. 501(c)(3) of the Code status differ from those of other organizations. I.R.C. Sec. 508(a) requires an organization seeking tax-exempt status under Sec. 501(c)(3) of the Code to "give notice" that it is applying for recognition of such status. Form 1023 provides the method for filing the notice. There is generally no comparable statutory requirement for organizations seeking exemption under other paragraphs of Sec. 501(c) of the Code. The courts have held that, where the operations of an organization qualify it as tax-exempt under the statute, application to the I.R.S. is not a condition precedent to tax-exemption. *See, e.g., Savings Feature of Relief Department of B&O R.R. Co. v. Commission*, 32 B.T.A. 295 (1935), *seq.*, 1935-1 C.B. 18. Although the I.R.S. has always taken the opposite position, it has made substantial concessions by its retroactive recognition of exempt status once a favorable ruling has been issued (Sec. 12.01 of Rev. Proc. 80-25, 1980-1 C.B. 667), and by the promulgation of Treas. Reg. Sec. 1.6033-2(c), to the effect that an organization claiming exempt status prior to the establishment of such status shall file Form 990, rather than a normal tax return, indicating its belief that the organization is exempt.

<sup>3</sup> I.R.C. Sec. 508(d)(2)(B) of the Code. The operative rules are set forth in Treas. Reg. Sec. 1.508-1(a)(2).

<sup>4</sup> *See* Instructions to Form 123 Revised June 2006 (Form 1023 Instructions) at pg. 4. Rev. Proc. 92-85, 1992-2 C.B. 490. While Rev. Proc. 92-85 fails to apply the automatic extension to the 15 month deadline for disclaiming treatment as a private foundation under I.R.C. Sec. 508(b), apparently the I.R.S. will be applying the automatic extension to this as well.

<sup>5</sup> There are limited circumstances under which organizations can request exemption retroactive to the date of incorporation when it files after the 27 month period has expired. In order to be eligible for such treatment the organization needs to demonstrate that "you acted reasonably and in good faith and that an extension will not prejudice the interest of government." *See* I.R.S. Publication 557, revised March 2005, entitled "Tax Exempt Status for Your Organization." The

In this situation, contributions made after the organization was formed but before the application for tax exempt status was filed will not qualify for income, gift and estate tax deductions.

In all cases, the appropriate application form, together with certain supporting materials required by the form, must be completed and submitted, along with the certificate of incorporation (or articles of association) and by-laws, to the EP/EO Division in Covington Kentucky.<sup>6</sup>

A “user fee” must be paid at the time a Form 1023 or 1024 is filed with the IRS. The fee (which must be in the form of a check or money order payable to the IRS)<sup>7</sup> must be submitted along with the application for recognition of tax-exempt status or the application will be returned.<sup>8</sup> The fees are as follows:

- \$150: Organizations whose annual gross receipts have not averaged (or are not expected to average) more than \$10,000 during its first four taxable years.
- \$500: Initial requests for recognition of tax-exempt status under Section 501(a) or 521 of the Code (except those above).

As of July 1, 2006, the filing fees will be as follows:

- \$300: Organizations whose annual gross receipts have not averaged (or are not expected to average) more than \$10,000 during its first four taxable years.
- \$750: Initial requests for recognition of tax-exempt status under Section 501(a) or 521 of the Code (except those above).

A sample of Form 1023 and samples of Form 2848 (Power of Attorney), Form 8718 (user fees) and an appropriate cover letter, are attached as Exhibits 19-22 in

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publication, as well as the form 1023 and the instructions, can be ordered by telephone by calling 1-800-TAX-FORM or downloaded from the I.R.S. website at [www.IRS.gov](http://www.IRS.gov).

<sup>6</sup> Applications must be submitted to the I.R.S. P.O. Box 192, Covington, KY 41012-0192. If you are using express mail or a delivery service 201 West River Center Blvd. Attn: Extracting Stop 312, Covington, KY 41011.

<sup>7</sup> If a certified check is sent with the Form 1023 or Form 1024, it may reduce the response time by as much as a month.

<sup>8</sup> If there is a special need for a quick turn-around on the exemption application, *e.g.*, a pending grant, it is worth setting this out in the cover letter. It may help in getting expedited treatment, though there is no guarantee. See publication 557 at pg. 3 for details of the information to be included in the letter.

Appendix B at the end of this book.<sup>9</sup> Please check the IRS website [www.IRS.gov](http://www.IRS.gov) for updated forms prior to filing.

## **B. FILLING OUT FORM 1023**

Read the official instructions accompanying Form 1023, as revised June 2006.<sup>10</sup> The following comments are designed to amplify the official instructions and to indicate the purpose of some of the questions asked on the application, in order to help you avoid pitfalls, which may lead to a denial of tax-exemption.

The main point to keep in mind is that the application must make a consistent and convincing case for tax exemption: activity codes, narrative of activities, description of fundraising plans, and budgets should all fit together. For example, there should be no problematic budget lines (such as unrelated business income) without an appropriate qualification in the narrative given in Part IV (*e.g.*, explaining the insubstantial nature of the unrelated business activity). The budget needs to reflect the sources of funds and the fundraising plans described in Part VIII, Question 4. Do not leave unanswered questions for the IRS reviewer.

### **1. What Forms to Complete**

Fill in pages 1 through 12 (Parts I-XI) of the form 1023 and additional schedules, if applicable. Part XI User Fee Information must be completed and a certified check for the correct fee, made payable to the Internal Revenue Service, must be attached.

Prior to submitting the application for federal tax exemption the organization must receive an Employer Identification Number (EIN) from the IRS. This is accomplished by filing a form SS-4 with the IRS (See the instructions attached as Exhibit 15).

A Power of Attorney, Form 2848, should be submitted with the Form 1023 if the organization wants to have its counsel speak with the IRS directly and receive copies of any correspondence. If it is not submitted or if it is improperly completed, the IRS will communicate with the taxpayer, and will not send copies of correspondence to the lawyer. (See Part I, Question 7, below.)

If the organization is filing for exemption after the end of the 27th month from the date of incorporation and is not filing Exhibit E to the form 1023 you should also include the first page of the form 1024. Doing so will enable the IRS to

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<sup>9</sup> Please note Form 8718 is no longer required to be completed. This information is now contained within the application, Part XI.

<sup>10</sup> You should also read I.R.S. Publication 557.

consider the organization to be tax exempt under Section 501(c)(4) from the date of incorporation through the date of filing of the Form 1023.

## 2. Amplification of Specific Questions

### a. Part I: Identification of Applicant

#### **Question 1:** *Full name of Organization*

The name of the organization should appear exactly as it does in the group's organizing document (ie the Certificate of Incorporation).<sup>11</sup>

#### **Questions 2 & 3:** *Address*

Use the mailing address for the organization (*i.e.*, where it receives mail), which can be a street address or a post office box.

#### **Question 4:** *Employer Identification Number*

An applicant must apply for and receive an Employment Identification Number ("EIN") before filing Form 1023. An EIN number can be assigned over the phone and the application form (SS-4) then faxed to the IRS as explained on the instructions to the SS-4. It can be very hard to get through on the phone, in which case you can mail the Form SS-4.

#### **Question 5:** *Month the Annual Accounting Period Ends*

An organization, which has been in existence for some period of time and has received income and paid out money will normally have determined an "annual accounting period" or "fiscal year" and may wish to retain it. If not, consider the following possibilities:

- The calendar year. This seems convenient and logical to many organizations. One disadvantage: because of the crunch of business in the few months prior to May 15(the date upon which the Form 990 would be due), clients may have difficulty getting an accountant (especially a *pro bono* accountant) to focus promptly on their audit.
- A year corresponding to the fiscal year of a primary or sole grantor. (For example, New York City's fiscal year is July 1 – June 30 and recordkeeping for many of its grants must be done based on the same 12 month period.)

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<sup>11</sup> See above Chapter Three concerning the effect an organization's name may have on its attempts to secure tax-exempt status.

- For new organizations, a year ending a month or two preceding the date of incorporation. This will enable the organization to defer its first filings of Form 990 and the Annual Report to the Office of the Attorney General, Charities Bureau for more than a year. For example, if the date of incorporation is May 1, 1997, a fiscal year of June 1 – May 31 means that the first filings must be made October 15, 1997. (four and a half months after the close of the fiscal year). If the fiscal year ends on April 30, the first filings would not be due until September 15, 1998.
- For new organizations, a year that will permit the organization to apply for a definitive ruling with respect to public charity status. In order to obtain a definitive ruling, the organization must have completed a tax year of at least eight months within one fiscal year. Assume the organization was incorporated on January 1, 1997. If the Form 1023 is filed in October 1997 and the organization chooses October 1 – September 30 as its fiscal year, it will have completed a first taxable year of more than eight months. If it chooses a fiscal year ending June 30, its first taxable year (January 1, 1997 – June 30, 1997) will have consisted of only six months and its second taxable year (July 1, 1997 – June 30, 1998) will not have been completed.

**Question 6:** *Contact Person*

Fill in the name and contact numbers of the person who has Power of Attorney from the organization or the person at the organization designated to handle the Form 1023 if no lawyer is handling the matter.

**Question 7:** *Authorized Representative*

If the organization would like its attorney to communicate directly with the IRS on its behalf, it will have to execute a Power of Attorney on Form 2848. Fill in the name of the attorney here.

**Question 8:** *Paid Consultant*

Provide information about persons, other than your officers, directors, trustees, employees, or authorized representative(s), including someone holding a power of attorney whom you paid, or promised to pay, to assist you in establishing your organization, developing programs to solicit funds, or otherwise advising you about organizational financial or tax matters. An attorney working on a pro-bono basis does not have to be listed.

**Question 9(a): Website**

Fill in the complete website address, as well as the addresses of any websites maintained on behalf of the organization. The content of the website should be consistent with the information given in the 1023, particularly in the narrative description given in Part IV.

**Question 10: Filing of Federal Income Tax Returns or Information Returns**

Only a very limited number of organizations are exempt from the requirement to file a Form 990. Those exempt from filing include: churches, church affiliated organizations, certain groups affiliated with governmental units and organizations whose gross revenues do not normally exceed \$25,000.<sup>12</sup>

**Question 11: Date Incorporated or Formed**

The date of incorporation is the date the certificate of incorporation was accepted for filing by the NYS Department of State (or equivalent agency in its state of incorporation). This date can be found on the filing receipt that was sent to the incorporator of the corporation. The date of formation of an unincorporated association is generally the date the articles of association were adopted.

**Question 12: Foreign Country**

If the organization is not incorporated in the United States you must indicate so.

**b. Part II: Organizational Structure**

**Questions 1 – 4 (b): Corporate Structure**

Check the box indicating the type of organization submitting the application. A copy of the documents pursuant to which the organization was formed must be attached. For example, in the case of a corporation, a copy of the certificate of incorporation with the Secretary of State's seal or other evidence of approval.

**Question 5: By-laws**

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<sup>12</sup> See 2005 Instructions for Form 990 and 990-EZ at pg. 2.

Indicate whether the organization has adopted by-laws.<sup>13</sup> A copy of the by-laws must be attached.

**c. Part III Required Provisions in Your Organizing Documents**

Make sure the certificate of incorporation and by-laws meet the requirements of Section 501(c)(3) of the Code. The certificate of incorporation must contain clauses:

**Question 1:** *Article and Paragraph that contains exempt purpose.*

- Identify the portion of the certificate of incorporation that states a corporate purpose consistent with section 501(c)(3).

**Question 2:** *Article and Paragraph that contains dissolution provision.*

- Provide that upon dissolution, all of the organization’s assets will be distributed for a purpose exempt under Section 501(c)(3) of the Code. If you are incorporated New York the organization cannot rely upon state law in lieu of a dissolution provision.<sup>14</sup>

If the clauses are missing, or if the language of the certificate of incorporation is not acceptable to the IRS, the certificate of incorporation generally must be amended prior to issuance of the determination letter.

**d. Part IV: Narrative Description of Your Activities**

Observe the following rules:

- Do not merely restate the purposes in the certificate of incorporation; this is unlikely to satisfy the IRS requirements.
- Give enough detail to show that each activity is within the intent of the statute.<sup>15</sup> The description should discuss the standards, criteria, procedures or other means adopted or planned by the organization for carrying out its activities.

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<sup>13</sup> I.R.S. reviewers often require a conformed copy of the by-laws (e.g., one with a cover sheet stating “The attached is a true copy of the by-laws adopted by the Board of Directors of the corporation on \_\_\_\_\_” and signed by two officers). Although Form 1023 provides a box that can be checked if the organization has not yet adopted by-laws, it appears that the IRS will not issue a determination letter until by-laws have been submitted.

<sup>14</sup> Form 1023 Instructions at pg. 7.

<sup>15</sup> Treas. Reg. Sec. 1.501(a)-(b)(1)(iii).

- Review the Treasury regulations and relevant revenue rulings to determine whether particular activities are likely to qualify the organization for tax-exempt status under Section 501(c)(3) of the Code, and to obtain language describing how particular activities contribute to the fulfillment of exempt purposes. Be free in using the IRS's own language, since the IRS is likely to find such language persuasive. The IRS Exempt Organization Handbook is a good source for such language.
  - Remember that this question, when the applicant is a corporation, refers to the activities of the corporation only, not those of the unincorporated association that might have preceded it. Activities of a corporation, prior to its incorporation, are not required or technically relevant and should only be described if helpful to the organization's application.
  - Answer all parts of the question carefully; the question requires that you describe the activities of the organization while including information that answers the following questions:
    - What is the activity?
    - Who conducts the activity?
    - When is the activity conducted?
    - Where is the activity conducted (for example: New York)?
    - How does the activity further your exempt purposes?
    - What percentage of your total time is allocated to the activity?
    - How is the activity funded?
  - List any alternative names under which you operate, including any "a/k/a" (also known as) or "d/b/a" (doing business as) names.
  - If available, the applicant should also attach newsletters, brochures, a paper copy of its website, or similar documents for supporting details of the narrative. Review these documents prior to submission to ensure that they present a consistent picture of the organization's activities.
- e. **Part V: Compensation and Other Financial Arrangements With Your Officers, Directors, Trustees, Employees, and Independent Contractors**

**Question 1(a):** *Officers, Directors and Trustees*

List the organization's officers, directors, and trustees regardless of whether or not they receive compensation. If these individuals are not compensated provide that information. Compensation includes (1) salary or wages, (2) deferred compensation, (3) retirement benefits, such as pensions or annuities, (4) fringe benefits, including but not limited to a personal vehicle, meals, lodging, personal and family educational benefits, low interest loans and payment of personal travel, entertainment or other expenses, and (5) bonuses.<sup>16</sup> If an officer, director or trustee is also an employee their complete compensation should be listed here. For these purposes, an officer is someone who can legally bind the corporation. You can use the organization's mailing address for each individual.

**Question 1(b): *Highest Compensated Employees***

List the organization's 5 highest compensated employees, only if those employees are or will be compensated at least \$50,000. The organization's mailing address may be used.<sup>17</sup>

**Question 1(c): *Highest Compensated Independent Contractors***

List the organization's highest compensated independent contractors only if those individuals are or will be compensated at least \$50,000, and their compensation. Independent contractors are persons who are not treated as employees for employment tax purposes.<sup>18</sup>

**Question 2: *Officer, Director and Trustee Family or Business Relationships***

"Family relationships" include the individual's ancestors, children, grandchildren, great grandchildren and siblings, as well as each of their respective spouses. "Business relationships" include employment and contractual relationships, and common ownership of a business where any officers, directors, or trustees, individually or together possess more than a 35% ownership interest in common. "Ownership" means voting power in a corporation, profits interest in a partnership, or beneficial interest in a trust.<sup>19</sup>

**Questions 2(a)** relates to relationships among directors.

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<sup>16</sup> I.R.S. Instructions to Form 1023, page 8.

<sup>17</sup> *Id.*

<sup>18</sup> *Id.*

<sup>19</sup> *Id.* at 9.

**Question 2(b)** When the application says “you” it is referring to the organization.

**Question 2(c)** Relates to the relationship among officers and directors and employees and independent contractors.

**Question 3:** *Qualifications officers, directors, highest compensated employees and highest compensated independent contractors.*

Please note that question 3 also includes highest compensated employees as well as independent contractors.

**Question 3(a):** *Qualifications*

We would recommend including a resume or bio for each individual.

**Question 3(b):** *Common Control*

“Common Control” means that a majority of the governing boards or officers of the organization and one or more other organizations are either (1) the same individuals or (2) appointed or elected by the same organizations.<sup>20</sup>

**Question 4:** *Compensation Agreements*

The IRS is concerned that exempt organizations adopt practices that prevent excess compensation going to the organization’s top officials. It is highly recommended that the organization adopt these procedures, although it is not required to achieve tax-exemption. If such procedures are not adopted, the organization must describe in item (g) how it sets compensation that is reasonable for its officers, directors, trustees and highest compensated employees and independent directors, as listed in Part V, Question 1.

“Reasonable compensation” is the amount that would normally be paid for similar services by other organizations under similar circumstances at the time the compensation arrangement is made. Establishing and documenting the decision to pay compensation and how it was determined to be reasonable compensation is important because excessive compensation may result in excise taxes on both the individual and the organization. In extreme circumstances excess compensation could jeopardize the organization’s attainment of tax-exempt status.<sup>21</sup>

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<sup>20</sup> *Id.*

<sup>21</sup> *Id.*

**Question 5: *Conflict of Interest Policy***

A “conflict of interest” arises when a person in a position of authority over an organization, such as a director, officer, or manager, may benefit personally from a decision he or she could make. Adoption of a conflict of interest policy is not required to obtain tax-exempt status, but is recommended. The IRS provides a sample policy in Appendix A to the Instructions to Form 1023 that is relatively straightforward. Adoption and observance of a conflict of interest policy will help avoid the possibility that those in positions of authority within the organization will receive an inappropriate benefit. If the agency opts not to adopt a conflict of interest policy it must explain the procedures it will follow to avoid any conflicts.<sup>22</sup>

**Question 6: *Non-Fixed Payments***

Describe all non-fixed payment compensation arrangements, if any, with the organization’s officers, director, trustees and employees and independent contractors. A non-fixed payment is a payment that depends on discretion or that is adjustable based on revenue. A fixed payment is a set dollar amount or an amount determined by a formula and does not have to be described here<sup>23</sup>

**Question 7: *Purchase or Sale of Goods, Services or Assets***

Describe past, or potential, purchases or sales of any goods, services or assets from or to any of the organization’s officers, directors, trustees and highest compensated employees and independent contractors, if any.

The description should include how the terms of the transaction were or will be negotiated at arm's length. Where the organization is conducting business with a person with substantial influence over the organization precautions must be taken to ensure that the negotiations are fair and that the transaction is in the best interest of the organization. Such precautions include using a conflict of interest policy.

The description of the transaction should also explain how the organization determined or will determine that it pays no more than fair market value. Fair market value is the price at which property or the right to use property would change hands between a willing buyer and seller, neither being under any compulsion to buy, sell, or transfer property or the right to use property, and both having reasonable knowledge of facts.

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<sup>22</sup> *Id.*

<sup>23</sup> *Id.*

Be sure to attach copies of any written agreements or contracts relating to such purchases or sales, where applicable. Do not include purchases or sales of goods and services in the organization's normal course of operations that are available to the general public under similar terms and conditions.

**Questions 8:** *Leases, Contracts, Loan or Other Arrangements with Officers, Directors, etc.*

If the organization will have any leases, contracts loans or other agreements with its officers, directors, trustees or highest compensated employees or independent contractors, answer "yes" to this question and provide the required information. In most, if not all circumstances, the organization should have a contract with a highly compensated independent contractor.

As with Question 7 the IRS is concerned that the agency not pay more than fair market value and that the transaction be negotiated at arm's length.

**Question 9:** *Leases, Contracts, Loan or Other Arrangements with Other Organizations*

If the organization will have any leases, contracts, loans or other agreements with any organization in which any of your officers, directors or trustees are also officers, directors or trustees, or in which any individual officer, director or trustee owns a 35% interest, answer "yes" to this question and provide the information listed in Question 8 above.

Answer "No" if the lease, contract or other agreement is with a 501(c)(3) organization.

As with Question 7 the IRS is concerned that the agency not pay more than fair market value and that the transaction be negotiated at arm's length.

**f. Part VI: Your Members and Other Individuals and Organizations that Receive Benefits from You**

**Questions 1(a)&(b):** *Goods, Services or Funds to Individuals/Organizations*

For each question, describe the services the organization offers to individuals and organizations respectively. You can repeat the information provided in response to Part IV, the narrative description of the organization's activities.

**Question 2: *Limits on Benefits, Services or Products***

This question pertains to two closely related aspects of obtaining recognition of tax exemption. The first concerns the “private benefit” test under Section 501(c)(3) of the Code, under which “no part of the net earnings ... inures to the benefit of any private shareholder or individual...” and the second relates to determining whether the organization is operated “exclusively” for exempt purposes.

For this reason, it is acceptable to say that the benefits will be limited to certain classes of people, (*e.g.*, the homeless, or low-income children in a particular neighborhood, etc.), so long as the class is “charitable.” Such limitations mean the organization’s activities are devoted exclusively to charitable purposes. Similarly, services can be offered to the community as a whole when the nature of services provided (*e.g.* educational or cultural programs) are exempt regardless of who participates in the programs. If, however, the organization’s exempt status depends on the nature of the beneficiaries (*e.g.*, the provision of low-income housing is charitable; provision of middle-income housing is not), exemption may not be granted if certain noncharitable classes of “private” persons benefit disproportionately from the organization's services.

For programs that are available only for members of the organization, include a sample membership application and a schedule of membership dues. Also, describe any different membership levels and the benefits each membership level receives.

**Question 3: *Family or Business Relationship with Individuals who Receive Goods, Services or Funds***

The concern raised by this question is that charitable assets should not be used to benefit a small group of individuals related to the organization’s management. If any individuals who receive goods, services or funds through the organization’s programs have a family or business relationship with any officer, director, trustee or highest compensated employees or independent contractors these relationships must be disclosed. It is important to explain why these related individuals are eligible for goods services or funds. Please refer to Part V, Question 2 above, for an explanation of family and business relationships.

**g. Part VII: Your History**

**Question 1: *Successor to Another Organization***

An organization is considered a successor if it has:

- Substantially taken over all of the assets or activities of another organization.
- Been converted or merged from another organization.
- Installed the same officers, directors, or trustees as another organization that no longer exists and had purposes similar to the current organization's purposes.

There is no prohibition against a for-profit organization converting to a not for profit organization which qualifies for tax exemption under Section 501(c)(3) of the Code.<sup>24</sup> Further, the officers, employees or directors of the founding organization may serve the exempt organization. However, the exempt organization must be a separate and distinct entity and must be operated for exempt purposes, rather than the purposes of the founding, controlling or affiliated organization. If the organization is successor to another organization, answer "yes" to this question and provide an explanation in Schedule G. An explanation might include the following:

- Name of the predecessor organization;
- Whether the predecessor ever received a ruling or determination that it was exempt from federal income tax, and if so, the date;
- The nature of the predecessor entity, *e.g.*, sole proprietorship, partnership, unincorporated association, corporation or trust (period of its existence);
- Reason for its termination; and
- If the predecessor was a for-profit entity, how the succession was structured to ensure that no private benefit was involved.

**Question 2: *Time Elapsed since Legally Formed***

"Legally formed" refers to the date of incorporation for a corporation, or date of formation if other than a corporation. If less than 27 months have passed, 501(c)(3) status will be retroactive from the date of legal formation. If more

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<sup>24</sup> See Rev. Rul. 4-243, 1954-1 C.B. 92.

than 27 months have passed, the organization will only be eligible for tax exemption under section 501(c)(3) from the postmark date of its 1023 application unless it requests an extension of the filing period and completes Schedule E to the Form 1023. In the event that the extension is not granted, however, the organization may still be eligible for tax exemption under 501(c)(4) from the date of formation to the postmark date of the application.

#### **h. Part VIII: Your Specific Activities**

**Question 1:** *Political Campaigns* This question relates to political campaign activity. 501(c)(3) organizations are barred from participating in any political activity.

**Question 2:** *Attempts to Influence Legislation and a 501(h) Election*

This question relates to the “legislative and political” activities limitations of Section 501(c)(3). Section 501(c)(3) organizations may only engage in limited lobbying.<sup>25</sup>

If question 2(b) is answered “yes”: (1) state that the organization is filing Form 5768 and that the organization will comply with the guidelines set forth in Section 501(h); or (2) state that any lobbying activities will be insubstantial and give the expected percentage of the organization’s time and funds. When an organization anticipates engaging in lobbying activity it will benefit from making the 501(h) election because it provides a bright line test for measuring the agency's acceptable lobbying activities.

**Question 4(a):** *Fundraising Program*

It is helpful in securing public charity status to show that the organization has a program to continuously attract public support (*e.g.*, regular submission of grant proposals to foundations, corporations and government agencies, mailings to the general public or a fundraising committee to oversee these activities). Be sure to attach a description of each fundraising program selected. This description can be as simple as a sentence or two.

**Question 4(b):** *Use of Professional Fundraisers*

You must disclose any relationships with fundraising professionals (other than employees) who have been retained to work with the agency. The IRS is concerned that professional fundraisers do not unduly benefit from a charitable organization.

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<sup>25</sup> See Chapter Six for a discussion of these limitations.

**Questions 6(a) &(b): *Economic Development***

Organizations that engage in economic development must provide a detailed explanation of activities. Organizations should demonstrate that the region in which they are working is economically depressed.

**Question 7 (a)–(c): *Facilities***

Exempt organizations need to ensure that charitable assets are being used in furtherance of all exempt purposes. The IRS is concerned that exempt organizations must not pay exorbitant facilities and management fees to related individuals or other not-for-profit businesses.

**Question 8: *Partnerships***

It is important that when exempt organizations enter into business relationships with other entities – especially for profit entities - that the exempt organization not bear a disproportionate amount of the risk.

**Question 9 (a)–(d): *Child Care Agencies***

Agencies that provide child care are not considered to be charitable within the meaning of section 501 (c)(3). Rather, if they are open to the general public and provide child care that enables parents to work, the agency will be considered exempt under section 501(k) of the Internal Revenue Code and assume all the benefits and obligations of (c)(3) entities.<sup>26</sup>

**Question 10: *Intellectual Property***

This question is especially pertinent for arts organizations where the creative talent may receive compensation from the exempt organization for developing intellectual property and then retain ownership of that property to the detriment of the exempt organization. An additional concern is that an exempt organization not be established to promote the work of any individual artist.

**Question 12: *Foreign Country***

Domestic agencies can receive exempt status when they operate abroad. The board of directors of the agency must retain discretion as to how charitable

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<sup>26</sup> Internal Revenue Code §501(k).

funds are spent. Sometimes agencies operating abroad need to be aware of the Patriot Act<sup>27</sup> limitations of transferring funds abroad.

**Question 13:** *Grants to Other Domestic Organizations*

The IRS is particularly concerned about inter-relationships between exempt organizations. For example if a 501 (c)(3) organization is making grants to a related 501 (c)(4) organization, the IRS is likely to have follow up questions to further probe these relationships. It is important to disclose any relationship the organization may have with any other organization, whether such organization is tax-exempt or not. Examples of relationships with other organizations, which should be disclosed, include, but are not limited to:

- significant overlap in officers, directors or employees between the applicant organization and another organization;
- situations where another organization is the sole member of the applicant organization or otherwise has the ability to control it.

If the organization with which the applicant has a relationship, and/or is a Section 501(c)(3) organization, be sure to state that fact, since a relationship with a 501(c)(3) is unlikely to be problematic and may be helpful. If the other organization is not tax-exempt, explain why the relationship does not involve private benefit or other problems (*e.g.*, risk of diversion of funds for non (c)(3) purposes).

**Question 14:** *Grants to Foreign Organizations*

Agencies giving dollars abroad will need to comply with all relevant provisions of the USA Patriot Act and related United States Treasury Regulations.

**i. Part IX: Financial Data**

Within 60 days prior to the date of filing Form 1023 complete Part IXA (Columns b-d) for each of the three fiscal years prior to the current fiscal year (or for the lesser number of years the organization has been in existence), and actual financial data for the current fiscal year (Column a) up to a date.

If the organization's first fiscal year has not ended, complete Part IX for the period starting with the date of incorporation and ending on a date no more than 60 days prior to the date of filing Form 1023. If the organization has

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<sup>27</sup> USA Patriot Act of 2001, PL 107-56; See also [www.ustreas.gov/press/releases/reports/2002910184556291211.pdf](http://www.ustreas.gov/press/releases/reports/2002910184556291211.pdf).

been in existence less than one year, also submit estimated budgets for the balance of the current fiscal year and the following two years.

If Form 1023 is filed less than 60 days after the date of incorporation, it is unnecessary to give actual receipts and expenditures for the current fiscal year (e.g., unnecessary to complete Column a). Submit estimated budgets for the organization's first two years, beginning the first budget with the date of incorporation and ending it on the last day of the fiscal year.

If the first year consists of less than twelve months, then submit projected budgets for the first three years.

Although a prescribed form of a Statement of Revenue and Expenses is provided in Section A of Part IX of the Form 1023, many of the categories will not be applicable to a recently formed organization. In such cases, it is appropriate to use a simpler format similar to the form budget included at the end of Exhibit 19 in Appendix B at the end of this book.

In completing Part IX, be sensitive to responses that may pose problems. Consider, for example, the following:

### **Statement of Revenues and Expenses (Section A)**

#### **Line 1:** *Gifts, Grants, and Contributions Received*

All income that the organization receives as a gift, grant or contribution should be listed here. This includes funds the organization receives from a governmental unit to provide services to the general public in furtherance of the organizations exempt purpose.

#### **Line 2:** *Membership Fees Received*

Membership dues (meaning monies that the member is giving in support of the organization) should be listed on line 2. Monies that a member pays as an admission fee or to purchase merchandise should appear on line 9.

#### **Line 3:** *Gross Investment Income*

The receipt of passive income ordinarily will not affect the exempt status of an organization. However, rents and royalties may give rise to a question concerning exempt status if they derive from the active conduct of a business.<sup>28</sup>

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<sup>28</sup> "See *D.A.V. v. U.S.*, 942 F.2d 309 (6th Cir. 1991); T.A.M. 9151001 (Dec. 20, 1991). See also Treas. Reg. Sec. 1.513-1(a)(4); *University Hill Foundation*, 446 F.2d 701 (9th Cir 1971); *Cooper Tire and*

**Line 4:** *Net income from unrelated business activities*

This item refers to income from business activities not related to the organization's exempt purposes and should be answered with caution. Entries on these lines probably will cause the IRS to consider whether the organization is operating primarily for business purposes unless Part II, Question 2 makes clear that the activities are insubstantial.<sup>29</sup>

**Line 9:** *Gross receipts from admissions, merchandise sold or services provided*

This line relates to fee for service income earned by the organization. If fee for service income is too high a percentage of the agency's income the organization may not be eligible for exemption as a charitable organization.<sup>30</sup>

**Line 12:** *Unusual Grants*

Unusual grants are large gifts that adversely affect the calculation of the organization's public charity status. They must be unusual, unexpected and from an unrelated third party.

**Line 14:** *Fundraising Expenses*

If an organization is hiring a professional fundraiser the related expenses must be listed on this line. If fundraising activities are being undertaken by staff members, those costs would be listed on either line 17 or 18 depending upon whom the staff member is.

**Line 15:** *Contributions, gifts, grants and similar amounts paid*

If another organization which has received contributions or gifts from the applicant organization is not listed in the latest Cumulative List of organizations which are exempt under Section 501(c)(3) of the Code (IRS Publication 78), indicate when the organization was granted (or applied for) recognition of its tax exemption, and list the addresses of all donees so the application is not delayed while the IRS tries to determine their status. Recipients that do not appear on their face to qualify as appropriate donees,

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*Rubber Co. Employees Retirement Fund*, 306 F.2d (6th Cir. 1962); Rev. Rul. 60-206, 1960-1 C.B. 201; Rev. Rul. 57-313, 1957-2 C.B. 316; Rev. Rul. 54-420, 1954-2 C.B. 128, as modified by Rev. Rul. 65-153, 1966-1 C.B. 187.

<sup>29</sup> See I.R.S. Publication 598, Tax on Unrelated Business Income of Exempt Organizations.

<sup>30</sup> See e.g., PLR 200610029; PLR 200523024.

based upon the exempt purposes of the organization, should be carefully explained in the schedule.

**Line 17:** *Compensation of officers, directors and trustees*

If compensation paid by the organization (to officers, directors, trustees, etc.) is excessive, this will create a “private benefit” problem, and questions as to the organization’s qualification for exempt status will be raised. This is particularly true where the individuals being so compensated are in positions of control over the organization.

**Line 19:** *Interest Expense*

The payment of interest by the applicant organization may raise some questions. First, exempt status may be affected by borrowing that is substantial enough to endanger the potential purposes (i.e., if the debt is so substantial that the organization’s revenues will be used to repay the debt instead of meeting the expenses of conducting exempt activities). Second, in some cases where there is rental or other income from “debt-financed property,” indebtedness may give rise to an unrelated business tax.<sup>31</sup>

**Line 20:** *Occupancy*

Excessive occupancy costs, especially to a “related” party, will give the impression of a “private benefit” problem and will raise questions as to the organization’s qualification for exempt status.

**Line 23:** *Other*

The appearance of certain items on the schedule may raise questions. For example, if the organization shows payments of any state or local taxes, the IRS may want to know whether a state or local government has found the organization to be non-exempt. Therefore, if the payment of taxes is not attributable to a determination of non-exemption at the state or local level (i.e., if the organization has chosen not to apply for exemption for some reason other than a belief that it would not qualify, or if exemption from the tax is not available to charitable, educational, etc., organizations), the organization should attach a statement explaining that fact.

**Balance Sheet (Section B)**

This has been changed so that the date of the balance sheet is the close of the last fiscal year. If the organization has not completed a fiscal year then

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<sup>31</sup> See discussion in Chapter Six.

include the most recent data and put the date the data is compiled as of in the year end line.

**Line 3: Inventories**

The inclusion of inventory as an asset may suggest that business operations are being conducted, unless the organization attaches a satisfactory explanation.

**j. Part X: Public Charity Status**

Organizations seeking tax exemption under Section 501(c)(3) generally want to be classified as a “public charity” rather than a “private foundation.” Private foundations, unlike public charities, are subject to more stringent financial reporting requirements, extra taxes and recordkeeping and limitations on how their money may be distributed. To avoid classification as a private foundation, an organization must be “publicly supported” in one way or another, rather than supported by a limited number of contributions. Certain organizations, *e.g.*, schools, churches and hospitals, need not meet the public support tests.<sup>32</sup>

**Question 1: Private Foundation Status**

Since private foundation status entails extra taxes and recordkeeping, as well as limitations on the use of funds, this question should not be answered “yes” until the organization has thoroughly explored all the alternatives. If the answer to this question is “yes,” proceed to Question 9.<sup>33</sup>

**Questions 2, 3 & 4: Private Operating Foundation Status**

A “private operating foundation” is a private foundation that spends substantially all of its adjusted net income or its minimum investment return, whichever is less, directly for the active conduct of the activities constituting the purpose or function for which it is organized and operated. If the organization is not a private operating foundation, check the “no” box and complete the financial data section of the Form 1023.

**Question 5: Public Charity Status**

The organization should check the box which best describes the reason why the organization is publicly supported and is not, therefore, a private foundation. Most organizations will fall under box (h) or (i). Box (h) should

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<sup>32</sup> See discussion of private foundation status in Chapter Six.

<sup>33</sup> See I.R.S. Publication 578, Tax Information on Private Foundations and Foundation Managers.

be checked if the organization receives a substantial part of its support from the United States or any state or political subdivision thereof, or from direct or indirect contributions from the general public or from a combination of these sources. Box (i) should be checked if the organization normally receives one-third of its support from gifts, grants, contributions and membership fees and 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. If the organization is in doubt as to whether it best fits the support test in box (h) or (i), it can check box (j) and the IRS will make the determination. However, it seems unwise to indicate this degree of uncertainty about the rules of public charity status and the applicant's ability to satisfy them.

If the organization checks the wrong box, the IRS will make its determination based on the appropriate support test and issue its determination accordingly. A Form 1023 will not be bounced simply because the organization used the wrong support test.

#### **Question 6:** *Type of Ruling*

An organization can apply for either a definitive ruling or an advance ruling regarding its public charity status depending on how long it has been in existence and what its sources of support have been. A definitive ruling grants the organization not only Section 501(c)(3) status, but also rules on its public charity status. In the case of an advance ruling, the IRS states in the determination letter granting Section 501(c)(3) status that it will presume for the moment that the organization is a public charity, but will review the organization's operations and sources of support 4 years from the end of the applicant's first fiscal year to make a final determination. (See Part X, Questions 1-5 for further discussion of public charity vs. private foundation status.)

To apply for a definitive ruling, the organization must have completed a fiscal year of at least eight months, during which time it met the requirements for public charity status. Assuming that the organization meets the requirements for obtaining exempt status retroactive to the date of incorporation, all months after incorporation can be counted. If the organization is filing Form 1023 more than 27 months after the date of incorporation, financial support prior to the date of filing does not count and the organization cannot apply for a definitive ruling.

If, prior to incorporation, the organization was functioning as an unincorporated association, which received recognition of tax-exempt status under Section 501(c)(3) of the Code and a definitive or advance ruling of public charity status, the number of months from the pre-incorporation

period to the present can be counted toward the eight months requirement. All Part II answers must discuss the pre-incorporation period, as well as past-incorporation period, if you wish to count that period toward the eight months.

If the organization is not eligible for a definitive ruling, it must seek an advance ruling.

### **Question 7: *Unusual Grants***

This question requires the organization to disclose any unusual grants it has received. An unusual grant is defined as a substantial contribution or bequest from disinterested persons that: (1) is attracted by reason of the publicly supported nature of the organization; (2) is unusual and unexpected as to the amount; and (3) would, by reason of its size, adversely affect the status of the organization as normally meeting the publicly supported test in either Section 170(b)(1)(A) (vi) or Section 509(a)(2) of the Code. If the organization has received such a grant, it must attach a list showing the name of the contributor by year, the date and amount of the grant and a brief description of the nature of the grant.

## **C. THE DETERMINATION LETTER**

The IRS will send a letter confirming receipt of the application for exemption; the letter promises review of the application within a certain number of days, a deadline sometimes met and sometimes not. It is not uncommon for the reviewer to send a list of questions before issuing the determination letter. This is a good opportunity to understand the reviewer's concerns and to respond to them effectively. After reviewing the application and the answers to any questions, the IRS will issue a "determination letter." The letter will state whether or not the exemption has been "recognized." Assuming that it has, the letter will also state whether the applicant qualifies as a public charity. If an advance ruling has been sought, the letter will state whether it appears that the applicant will qualify as a public charity and, if so, the date on which the "advance ruling period" will end. The organization will have 90 days from the end of the advance ruling period to submit financial information demonstrating that it has in fact met the requirements of public charity status.

An advance ruling relates only to determination of public charity status and does not mean that the organization's 501(c)(3) status is provisional. The organization retains its 501(c)(3) status unless it fails to comply with the requirements of exemption. The review at the end of the advance ruling period goes only to public charity status—it is not a review of 501(c)(3) status.