

GUIDE TO TAX-EXEMPT NPOS Part 1 Definitions & Differences

Part 1 of a quick look at what it takes to set up a charitable-purpose nonprofit corporation in California and Arizona, motivate a Board of Directors, obtain and keep tax-exempt status, and maintain funding to permit the team to achieve charitable goals.

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CHAPTER 1. Introduction, vocabulary, and definitions

What is needed to organize and operate a start-up nonprofit in California or Arizona? Foremost, you must know, gather, motivate, and maintain a group of supporters composed of good people, who know other good people, and are willing to lean in and contribute to something worth their time. They will hopefully help out financially to get things going, and then provide members for your first Board of Directors. The nonprofit organization (NPO) will always depend on its Board, which always depends on its Directors.

1.1. Deciding on a purpose, form, and state of incorporation

1.1.1. Purpose

Nonprofits may only engage in certain activities, charitable, educational, religious, scientific, or literary purposes. Principally, but not limited to:

- (1) Charitable purposes: such as providing relief for the poor, distressed, or underprivileged; advancing education or science; supporting healthcare initiatives; and protecting human rights.
- (2) Educational & Literary activities: such as operating schools, universities, libraries, or research institutions.
- (3) Religious activities: such as maintaining churches, temples, mosques, and other places of worship or associations.
- (4) Scientific & Public Safety purposes: such as conducting research for public

benefit, medical advancements, or testing products for public safety.

(5) Social Welfare & Community Improvement; including activities to lessen neighborhood tensions, eliminate prejudice, defend civil rights, and combat community deterioration.

(6) Sports & Animal Welfare: such as fostering national or international amateur sports competitions and preventing cruelty to children or animals.

Many nonprofits assert a generic “charitable purpose”, which requires it to flesh out the particular expression of that charitable purpose and the goal it hopes to achieve.

1.1.2. Form of entity

In terms of the best form of entity, I recommend forming a nonprofit corporation without voting members. Nonprofits may take a variety of organizational forms, such as an LLC or trust, but the corporate form is tried and true, and we know how the law will apply and what to expect in our interactions with the IRS and any state regulators.

1.1.3. State of incorporation

The corporation should be formed in the state in which it will have its principal office and conduct its operations, usually where the organizing principals live. Some states have greater registration and reporting requirements than others, but you should play this safe. If a corporation conducts operations in a state other than the one in which it was formed, then it probably needs to register, or “qualify” with the Secretary of State (or Corporation Commission) with each state in which it is conducting its operations. Try to avoid filings in additional states, which will each have their own additional periodic requirements and fees.

A nonprofit is considered to be doing business in California, for example, when it solicits donations in California “by mail, by advertisements in publications or by any other means from outside of California.” Other examples of doing business in California include maintaining an office, holding meetings of the board of directors or corporate members, having officers or employees who perform work, and/or conducting charitable programs in the state. Note, however, that neither making grants to persons or organizations located in California, nor maintaining financial accounts or investments at a financial institution’s office located in California, alone rises to the level of doing business in the state for Attorney General registration and reporting purposes.

1.2. Difference between “nonprofit” and “tax exempt”

You may form a nonprofit corporation through the Secretary of State (or Corporation Commission) and the newly formed corporation must then engage in its designated nonprofit activities. It may be automatically exempt from some state charges, depending on jurisdiction, but must still pay the state’s franchise tax, and donations to the entity are NOT tax deductible for the donor.

The nonprofit must take the further steps of applying for, and receiving, tax-

exempt status from the IRS and any required state agency. California, for example, requires a separate application for it to grant tax-exemption.

1.3. Difference between “public charity” and “private foundation”

The IRS recognizes two basic forms of 501(c)(3) tax-exempt organizations: (1) public charities and (2) foundations.

1.3.1. Public Charities

Public charities generally receive a greater portion of their financial support from the general public or governmental units, and have greater interaction with the public. At least 33.3% of its donations must come from donors who each give less than 2% of the nonprofit’s overall receipts. More technically, 501(c)(3) public charities must pass one of two test: (1) organizations described through the combined effects of sections 509(a)(1) and 170(b)(1)(A)(vi) of the Tax Code, and (2) organizations described in section 509(a)(2). These code sections are discussed below at 1.6.

1.3.2. Private Foundations

A private foundation, on the other hand, is typically controlled by members of a family or by a small group of individuals, and derives most or all of its support from a small number of sources and from investment income. Because they are less open to public scrutiny, private foundations are subject to various operating restrictions and to excise taxes for failure to comply with those restrictions. Similarly, private foundations do not need to pass the public support test, which means a private foundation can be (and often is) solely funded and controlled by one person, a family, a business or a small group of people with a common interest. Revenue of a private foundation is derived from this small pool of donors or from investments, not from donations from the general public and not from program service revenue.

Upon formation, a section 501(c)(3) organization is presumed to be a private foundation unless it requests, and qualifies for, a determination that it is a public charity. Organizations that qualify for public charity status also include churches, schools, hospitals, medical research organizations, publicly-supported organizations (i.e., organizations that receive a specified portion of their total support from public sources), and certain “supporting organizations” which actively support another “supported” public charity.

Private foundations are required to distribute a minimum "distributable amount" of whatever they take in, calculated according to a formula, with certain exceptions for setting aside funds for certain projects for certain periods. If the required amount is not distributed every year the corporation is subject to a 30 percent excise tax under section 4942 on the undistributed income, for each year or partial year that the deficiency remains uncorrected, and an additional 100 percent tax is triggered if the foundation fails to make up the deficient distribution within 90 days of receiving notification from the IRS of its failure to make minimum distributions. You will need good accounting and CPA-level advice on these issues.

The deductibility of donations to POFs get better treatment than ordinary foundations. Donations to public charities can be tax deductible up to 60% of a taxpayer's AGI while donations to private foundations are limited to 30% of AGI. POFs, however, are allowed a stepped up level of deductibility to 50% of AGI.

Interestingly, a 501(c)(3) public charity may refer to itself as a "Foundation" because of the generic meaning of the single word. While the IRS distinguishes between public charities and private foundations, the word "foundation" may be used to signify an NPO's philanthropic, grantmaking, or fundraising nature. It may, however, discourage smaller contributions from knowledgeable public donors.

1.4. Difference between an "operating" and a non-operating foundation

Private foundations come in two flavors: (a) regular and (b) "operating". The regular or standard private foundation is created by a single benefactor or family, and it don't carry out any direct charitable activities. Instead, these private foundations fund the activities of other nonprofits to help them achieve their tax-exempt purposes. They must distribute at least five percent (5%) of their assets each year to their charitable priorities, often through grants, scholarships or other donations to public charities.

A "private operating foundation" (POF) is a foundation which, instead of, or in addition to, funding others, also engages in hands-on charitable activities or research. It needs to spend at least eighty-five percent (85%) of its adjusted income on direct action to qualify as a POF. An entity can change to a POF any time its expenditures reach the 85% threshold.

In addition, a POF must meet one of the following tests on an ongoing basis:

(1) the Assets Test requires that at least 65% of a POF's assets:

- (a) are devoted to the active conduct of its exempt activity, or of a functionally related business, or a combination of the two, or
- (b) consist of stock of a corporation that is controlled by the POF and at least 85% of the assets are devoted to the active conduct of its exempt activity, or
- (c) any combination of the above

(2) the Endowment Test requires that the POF normally make qualifying distributions for the active conduct of its exempt activities in an amount of at least two-thirds of its minimum investment return.

(3) the Support Test requires that:

- (a) at least 85% of its support is normally received from the general public,
- (b) not more than 25% of its support is normally received from any one exempt organization, and

(c) not more than 50% of its support is normally received from gross investment income.

1.5. Difference between a religious and a nonprofit corporation

As noted above, a 501(c)(3) public-benefit nonprofit can be formed for religious purposes. Most states, including California and Arizona, also permit the formation of religious corporations. Religious corporations are formed primarily to acquire, hold, and dispose of property for religious, charitable, or public worship purposes, including supporting churches or religious societies. These entities are structured as nonprofits to facilitate religious teaching, manage church assets, and protect the right to self-governance in internal affairs. They are subject to special rules and requirements, and donations to churches, conventions, or associations of churches are generally automatically tax-exempt under section 501(c)(3). They are not required to file for recognition to be exempt and are not required to file annual 990 returns.

1.6. Difference between §§ 509(a)(1) / 170(b)(1)(A)(vi) and § 509(a)(2)

When reading IRS instructions and explanations, you will read how 501(c)(3) public charities come in two flavors, pursuant to IRC Sections 509(a)(1) and 509(a)(2), with different funding tests.

1.6.1. IRC § 509(a)(1)

Section 509(a)(1) identifies the forms of public charities by excluding them from the otherwise all-embracing definition of “private foundation”:

“(a) General rule

For purposes of this title, the term “private foundation” means a domestic or foreign organization described in section 501(c)(3) other than—

(1) an organization described in section 170(b)(1)(A) (other than in clauses (vii) and (viii))”

So if an entity is described in § 170(b)(1)(A) (but not clauses (vii) and (viii)), then it is not a private foundation.

The 509(a)(1) test also requires that the NPO (1) receive AT LEAST 33.3% of its support from contributions from the general public OR if under one-third, (2) meet a 10% “facts and circumstances” test. This test requires that under all the facts and circumstances the NPO normally receives a “substantial part of its support from governmental units or the general public” of at least 10%.

1.6.2. IRC § 170(b)(1)(A)(vi)

Section 170(b)(1)(A)(vi) in turn describes the various expressions of public charities, but without naming them as charities, in terms of their purpose, activities, or funding. So nonprofits engaged in the following activities are included in the 509(a)(1)

category of public charities.

“(b) Percentage limitations

(1) Individuals

...

(A) General rule

(i) a church or a convention or association of churches,

(ii) an educational organization which normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on,

(iii) an organization the principal purpose or functions of which are the providing of medical or hospital care or medical education or medical research, if ...

(iv) an organization which normally 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, and which is organized and operated exclusively to receive, hold, invest, and administer property and to make expenditures to or for the benefit of a college or university ...,

(v) a governmental unit referred to in subsection (c)(1),

(vi) an organization referred to in subsection (c)(2) which normally receives a substantial part of its support ... from a governmental unit referred to in subsection (c)(1) or from direct or indirect contributions from the general public,

...

(ix) an agricultural research organization directly engaged in the continuous active conduct of agricultural research ..., or

(x) an organization described in section 501(c)(19) that is a federally chartered corporation.”

1.6.3. IRC § 509(a)(2)

Section 509(a)(2) identifies another variety of public charity by similarly excluding it from the definition of “private foundation” based on its funding:

“(2) an organization which—

(A) normally receives MORE THAN one-third of its support in each taxable year from any combination of—

(i) gifts, grants, contributions, or membership fees, and

(ii) 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 (within the meaning of section 513), not including such receipts from any person, or from any bureau or similar agency of a governmental unit (as described in section 170(c)(1)), in any taxable year to the extent such receipts exceed the greater of \$5,000 or 1 percent of the organization’s support in such taxable year, from persons other than disqualified persons (as defined in section 4946) with respect to

the organization, from governmental units described in section 170(c)(1), or from organizations described in section 170(b)(1)(A) (other than in clauses (vii) and (viii)), and

(B) normally receives NOT MORE THAN one-third of its support in each taxable year from the sum of—

(i) gross investment income (as defined in subsection (e))

and

(ii) the excess (if any) of the amount of the unrelated business taxable income (as defined in section 512) over the amount of the tax imposed by section 511.”