



7 Steps for Success After Forming a Section 501(c)(3) Organization

Section 501(c)(3) status comes with a number of operational and compliance requirements that must be followed in order to maintain federal income tax exemption.¹ This guide highlights key Section 501(c)(3) requirements that should be continuously monitored to ensure successful operations as an organization moves forward after its formation.

1. Ensure information returns are filed annually with the IRS

Most Section 501(c)(3) organizations (referred to herein as “a charity,” “charities,” or “charitable organizations”) must file a Form 990, Form 990-EZ, Form 990-N, or Form 990-PF annual information return with the IRS.² The annual filing requirement begins with the taxable year in which the entity is formed, whether or not it has received a tax exemption determination from the IRS. If an organization fails to file for three consecutive years, the IRS will revoke its tax-exempt status. A charitable organization that loses its tax-exempt status can apply for retroactive reinstatement, but it will need to demonstrate that there was reasonable cause for the failure to comply. Many charitable organizations find it helpful to hire an accounting firm to assist with federal and state tax return preparation and filing.

2. Satisfy the requirements imposed with respect to charitable solicitations / fundraising


The IRS imposes recordkeeping and substantiation rules on donors who make charitable contributions, and it imposes separate disclosure rules on charities that receive certain contributions where the donor receives goods or services in connection with the contribution.

Before donors can claim a charitable contribution on their federal income tax returns, they must (a) have a bank record or written communication from the charity evidencing any monetary contribution and (b) obtain a written acknowledgment from the charity for any single contribution of \$250 or more. Although it's a donor's responsibility to obtain a written acknowledgment so the donor can claim the tax deduction, a charity will often voluntarily assist a donor by providing a timely, written statement containing:

- the name of the organization;
- the amount of a cash contribution;
- a description (but not the value) of any non-cash contribution; and either
 - a statement that no goods or services were provided by the organization in return for the contribution, if that was the case; or
 - a description and good faith estimate of the value of goods or services, if any, that an organization provided in return for the contribution.

A separate acknowledgment may be provided for each single contribution of \$250 or more, or one acknowledgment, such as an annual summary, may be used to substantiate several contributions of \$250 or more. There are no IRS forms for the acknowledgment.

The obligation to obtain the written acknowledgement discussed above falls on the donor. However, the IRS does require charitable organizations to provide a written disclosure to a donor who receives goods or services in exchange for a single contribution in excess of \$75 (such as a meal at a fundraising event).



Many states have laws regulating the solicitation of funds for charitable purposes (i.e., engaging in fundraising). These statutes generally require organizations to register with a state agency before soliciting the state's residents for contributions. A simple "Donate Now" button on a website could trigger a registration requirement in several states. Organizations may also be required to file periodic financial reports. State laws may impose additional requirements on fundraising activity involving paid solicitors and fundraising counsel.

3. Do not engage in a transaction that provides substantial private benefit or any private inurement

Federal law prohibits a Section 501(c)(3) organization from providing substantial private benefits. A private benefit occurs when the income or assets of the organization are employed to benefit a private person. It is important to distinguish between private persons and a class of people that an organization's exempt purpose may target to benefit. If the private benefit conferred is incidental to achieving the exempt purpose, then the benefit is permissible. This analysis is both qualitative and quantitative in nature.

A subset of private benefit is private inurement. Private inurement is any private benefit that is provided to an insider of the organization (such as excessive compensation or lavish gifts). This generally includes any persons in control of the organization (and persons related to them), such as founders, directors, officers, and key employees. Any level of private inurement is strictly prohibited. Violation of this prohibition may result in revocation of tax-exempt status and the imposition of certain excise taxes.

4. Do not engage in substantial lobbying or any political campaign activities

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 public office. Contributions to political campaign funds or public statements of position (oral or written) made on behalf of the organization in favor of or in opposition to any candidate for public office clearly violate the prohibition against political campaign activity. Violating this prohibition may result in revocation of tax-exempt status and the imposition of certain excise taxes.

Certain activities or expenditures may be permissible depending on the facts and circumstances. For example, certain voter education activities (including presenting public forums and publishing voter education guides) conducted in a non-partisan manner do not constitute prohibited political campaign activity. In addition, other activities intended to encourage people to participate in the electoral process, such as voter registration and get-out-the-vote drives, would not be prohibited political campaign activity if conducted in a non-partisan manner. On the other hand, voter education or registration activities with evidence of bias that (a) would favor one candidate over another, (b) oppose a candidate in some manner, or (c) have the effect of favoring a candidate or group of candidates, would constitute prohibited participation or intervention.

Some lobbying by a charitable organization is permitted; it just cannot constitute a significant part of the organization's activities. Lobbying is defined as any attempt to influence legislation. Legislation includes action by Congress, a state legislature, or a local council or similar governing body. It also includes action by the general public in connection with a referendum, initiative, constitutional amendment, or similar

procedure. Lobbying does not include the discussion or advancement of general policy positions. So nonpartisan research or study of an issue, even if it may be the subject of proposed or pending legislation, is permitted as long as it does not advocate adoption of specific legislation or a specific legislative activity. Further, lobbying does not include technical assistance or testimony given at the request of a governmental body.

Finally, a self-defense exception permits an organization to communicate with legislators regarding any possible legislative decision that may affect the existence of the organization, its powers and duties, its tax-exempt status or the deductibility of contributions to it.

For purposes of charitable organizations, lobbying is divided into “direct lobbying,” which occurs when the organization communicates directly with legislators and their staffs regarding specific legislation (including by testimony), and “grassroots lobbying,” which occurs when the organization communicates with the general public regarding specific legislation and encourages them to contact their legislators.

The determination of whether the degree of lobbying is substantial is based on a facts-and-circumstances analysis. Some factors that may be considered include the percentage of time and expenditures allocated to lobbying. Organizations that know they will engage in regular lobbying activities and that want a degree of certainty to the substantial amount analysis may make an election with the IRS to have substantiality measured by the amount of expenditures on lobbying.

5. Be aware of unrelated business income which may be subject to taxes

The IRS imposes a tax on any unrelated trade or business taxable income of a Section 501(c)(3) organization. This tax is commonly referred to as unrelated business income tax, or UBIT. An unrelated trade or business is any activity that is regularly carried on for the production of income and that is not substantially related to achieving the organization’s exempt purpose. Engaging in a business merely to raise income to fund activities supporting an exempt purpose does not make the business related to the exempt purpose. A Form 990-T must be filed if an organization has gross unrelated business taxable income above a certain amount.

Some income of a charitable organization is not subject to UBIT, including, generally:

- investment income, such as dividends, interest, and capital gains;
- income generated through the services of volunteers;
- income from business activities that are provided primarily for the convenience of members, exempt program participants or beneficiaries, or employees of the organization;
- providing low-cost items such as a T-shirt or coffee mug to donors in connection with a donation is not considered a business sale; and
- the sale of certain sponsorships for events hosted by the organization, such as an annual fundraising dinner.

6. Monitor sources and amounts of funding which may affect an organization's characterization as a public charity

How a Section 501(c)(3) organization raises its funds is important. A Section 501(c)(3) organization is either classified as a public charity or a private foundation based on the sources of its funding. The default classification is as a private foundation unless the organization can show that it is publicly supported. There are significant benefits to being classified as a public charity. The rules governing private foundations are in some ways more complex and restrictive than those governing public charities.

Public charity status can be achieved several ways. First, if at least one-third of the organization's total support is normally from donations or grants made by the public, other public charities, or governmental entities, then the organization should qualify as a public charity. In counting donations from the public, the amount of a donation that is considered from any one public source for purposes of this test is limited to 2% of the organization's total support.

There is an alternative test for organizations that, by their nature, are not properly classified as private foundations, but that do not meet the one-third public support test. Under this alternative test, in addition to facts and circumstances that support the public nature of the organization, it normally receives at least 10% of its total support from donations or grants made by the public, other public charities, or governmental entities (e.g., a museum or library that relies on a large endowment rather than donations for most of its support). A second way public charity status can be achieved if at least one-third of the organization's total support is income from activities related to its exempt purpose (such as admission fees to a museum or thrift store sales) and less than one-third of its total support is from investment income.

7. Satisfy public disclosure requirements

Section 501(c)(3) organizations must make their applications for federal income tax exemption and their annual information returns available to the public for inspection and copying upon request. Copies usually must be provided immediately in the case of in-person requests, and within 30 days in the case of written requests. The organization may charge a reasonable copying fee plus actual postage, if any. If a charitable organization makes its public disclosure documents "widely available," it does not have to provide copies to individual requestors. Documents are considered widely available if they are readily available on the organization's website. While a file accessible on a website is an acceptable alternative to providing copies of these documents (either in response to an in-person or written request), the documents still must be available for public inspection during regular business hours.

In addition, the IRS makes these documents available. These applications and returns may include information about the organization's finances, related entities, grant-making, and compensation paid to directors, officers, key employees, and certain highly compensated employees and independent contractors. Some states also post charitable solicitation registration filings online. As a result, an organization's practices and activities are subject to significant public scrutiny.

Conclusion

Section 501(c)(3) organizations are subject to a variety of complex federal, state, and local rules and requirements. Operating even a modest organization in compliance with these rules requires diligent effort and an ongoing commitment of time, attention, and resources. Failure to devote the necessary time and effort to the operation of a charitable organization invariably leads to problems, many of which can be costly to resolve. Parties that have formed a Section 501(c)(3) organization should adopt procedures and structural mechanisms to carry out these obligations.

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Endnotes

¹ All Section references are to the Internal Revenue Code of 1986, as amended. The following discussion generally focuses on federal tax law requirements and does not address state or local requirements.

² Certain Section 501(c)(3) organizations, including churches, are not subject to this annual filing requirement.