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Kansas and Missouri Nonprofit/Tax Exempt Organizations - 2020

Nonprofit or tax exempt organizations have three major legal issues: (1) incorporating, (2) establishing and maintaining tax exempt status, and (3) handling donor contributions and deductions. This memo updates prior Kansas and Missouri analysis.¹

1. INCORPORATING NONPROFITS

Introduction

As attorneys, we are blessed to counsel nonprofit clients, whether starting a small nonprofit to honor someone's legacy or helping guide and steward a venerable national institution through the deep oceans of compliance. Attorneys advising tax exempt organizations should consult various resources.² Often clients want to make tax deductible contributions to a tax exempt organization.³

A tax exempt organization is a corporation, trust, or other entity and can come in many shades: they are usually charitable organizations, but can have other nonprofit purposes.⁴ Tax exempt organizations (1) do not pay federal income tax to the Internal Revenue Service (IRS) or many state taxes, (2) may provide tax deductions to donors for

¹ See Andres & Johnson, "Incorporating Nonprofits" and "Establishing Tax Exempt Status" (NBI, 2015), and Johnson, "Handling Contributions and Deductions" (unpublished).

² See Bruce R. Hopkins, *The Law of Tax Exempt Organizations* (Wiley, 12th ed., 2019) ("Tax Exempt"), *Nonprofit Law Dictionary* (Wiley, 2015), *Legal Responsibilities of Nonprofit Boards* (2nd ed. 2009), and *Starting and Managing a Nonprofit Organization* (Wiley, 7th ed., 2017) ("Nonprofit"), *Tax Law of Charitable Giving* (Wiley, 5th ed., 2014); see Marilyn E. Phelan, *Representing Nonprofit Organizations* (Thomson Reuters, 2019) ("Nonprofit Organizations") and *Nonprofit Organizations: Law and Taxation* (Thomson Reuters, 2019) ("Nonprofit Law"); see Lesley Rosenthal, *Good Counsel: Meeting the Legal Needs of Nonprofits* (Wiley, 2012), the IRS website (www.irs.gov) and publications, and the Nonprofit Law Center website (<http://www.nonprofitlawcenter.com>). Kansas nonprofits, K.S.A. §17-6001 *et seq* (West Supp. 2019); see Jason P. Lacey, *Kansas Corporate Practice and Forms* (2014); see Alson R. Martin ed., *Kansas Corporation Law & Practice* (KBA, 5th ed., 2011). Missouri nonprofits, V.A.M.S. §355.001 *et seq* (West Supp. 2019); see Thomas W. Van Dyke, *Missouri Corporate Practice and Forms* (2014); see Eric Ziegenhorn & Elizabeth Fast, *Missouri Practice* Vol. 7A (Thomson Reuters, 2015), Ch.48; Philip G. Louis, Jr., *Missouri Practice*, Vol. 25 (2015), §1.9, and Vol. 26 (2015), Ch. 3. See Hugh K. Webster, *Tax Exempt Organizations: Operational Requirements* (Bloomberg BNA No. 451, 2015), *Tax Exempt Organizations: Organizational Requirements* (Bloomberg BNA No. 450, 2015), *Tax Exempt Organizations: Reporting, Disclosure, and Other Procedures* (Bloomberg BNA No. 452, 2019).

³ "Nearly always, those who start a nonprofit organization ... want [the organization] to be eligible to receive tax deductible contributions. [People] equate *nonprofit* organizations with *tax exempt* organizations and ... with *charitable* organizations." Hopkins, *Nonprofit*, x. Lest any soul get lost in the morass of nonprofit terms, helpful dictionaries abound. *Id.*, 341-351, and *Nonprofit Law Dictionary*.

⁴ See Hopkins, *Tax Exempt*, Chs. 6-12 (charitable), and Chs. 13-19 (other nonprofits).

their donations, and (3) often must file a Form 990 to report annual income and expenses.⁵ Under the charitable organization umbrella are charitable, educational, scientific, and religious entities, public charities and private foundations, or other nonprofit purposes.⁶

Americans have a rich and storied history of philanthropic, educational, religious, and charitable, and other nonprofit endeavors. Kansas City has a generous philanthropic community.⁷ The threads of America's philanthropic tapestry were woven into the canvas of our Republic before tax exempt status was born.⁸ This philanthropic tapestry is founded on the great pillars of American democracy.⁹

Tax exempt status for charitable organizations was first enacted in 1894 and recognized constitutionally in 1913 when the U.S. income tax was ratified.¹⁰ Kansas and

⁵ See Martin, *Kansas Corporation Law*, §12.6.3. Mr Hopkins wrote: "Despite its size, complexity, and overreaching," "the revamped Form 990 is a work of art." Indeed, for "large exempt organizations, proper preparation ... is a mighty feat." The new Form 990 is "akin to ... a mammoth set of regulations." Form 990 is "modifying the behavior of the leaders, managers, and representatives ... of exempt organizations ... [in developing] policies, procedures, protocols, and other forms of governance practices." Hopkins, *Tax Exempt*, xxxi; Hopkins, *Nonprofit*, 119-128.

⁶ See Hopkins, *Tax Exempt*, Chs. 7 (charitable), 8 (educational), 9 (scientific), 10 (religious), 12 (private foundations), and 11 (other nonprofits); see Rosenthal, *Good Counsel*, 4-6; see Martin, *Kansas Corporation Law*, §12.6.2; see Phelan, *Nonprofit Law*, §16:19 (Kansas church incorporation); see V.A.M.S. §355.025; see Robert T. Napier, "Private Foundations and Donor Advised Funds," *Trusts & Estates*, June 2014, 56.

⁷ Ewing Kauffman (Kansas City Royals and Kauffman Foundation), Julia Kauffman (Kauffman Center), James Stowers (Stowers Institute), Henry Bloch (Bloch Foundation, St. Luke's Hospital, and the Nelson), William Nelson (Nelson-Atkins Art Museum), Uriah Epperson (Epperson House), Linda Hall (Linda Hall Library), Harry Lloyd (charitable trust), and Crosby Kemper (KC Symphony, the National World War I Museum & Memorial, American Royal, and Kemper Museum patron), and "lest the ages forget," R.A. Long and J.C. Nichols (the Liberty Memorial). Many philanthropists are anonymous. Donor advised funds (DAFs) are a great giving tool for large and small gifts alike. Hopkins, *Nonprofit*, 205-210. DAFs or charitable trusts work well for planning giving. *Id.*, 233-249.

⁸ Upon visiting America, the Frenchman Alexis de Tocqueville (1805-1859) wrote: "Americans of all ages, all conditions, and all dispositions constantly form [nonprofit organizations]." Hopkins, *Nonprofit*, 4. Indeed, "The activities of tax exempt organizations are tightly woven into American society" and their "importance to [America's] development" "should not be underestimated." Webster, *Operation*, A-1.

⁹ American democracy has three strong parts: "[1] a government sector, [2] a private ... sector, and [3] a nonprofit sector. Each sector must function effectively and must cooperate with the others ... if the democracy is to persist for the good of the individuals in the society ... [a democracy] can solve ... problems with minimal [government] involvement ... if there is a well developed and active nonprofit sector ... and similar private agencies." Hopkins, *Nonprofit*, 3. Alexis de Tocqueville pronounced America "the most democratic country on the face of the earth," where people "have in our time carried to the highest perfection the art of pursuing in common the object of their common desires, and have applied this new science to the greatest number of purposes." *Democracy in America*, Book 2, Ch. 5. Governments (1) exempt "most nonprofit organizations" from taxes and (2) allow "tax deductible gifts to them," two crucial needs "for the survival of many nonprofit organizations." Hopkins, *Nonprofit*, 3.

¹⁰ See Hopkins, *Tax Exempt*, §2.4. The 1894 Revenue Act began the trend, exempting nonprofits from corporate income tax. Webster, *Organization*, A-1. "Tax exemption was (constitutionally) introduced in

Missouri have long recognized tax exempt organizations.¹¹ America leads the world in philanthropic generosity, and in 2014, Americans donated more than \$358 billion to nonprofits.¹² 72% of charitable giving is by individuals.¹³ Nonprofits employ some 13 million Americans and account for about \$1 trillion in annual revenues and expenditures.¹⁴ As attorneys, we want to provide the best corporate governance counsel and tax advice to nonprofits, and we will likely be actively involved in starting, guiding, or participating in and donating to these organizations.

I. Unincorporated Organization Liability

There are three types of nonprofit organizations: (1) a corporation, (2) a trust, or (3) an unincorporated association.¹⁵ Attorneys guide clients to see an organization's beginning and end, how its bright mission illuminates its trajectory, embracing each moment on the organization's visionary arc.¹⁶ Why incorporate? Like a general partnership, unincorporated organizations have two levels of liability. First, at the organizational level, an organization's creditors can levy, attach, claim, or sue upon an individual's assets.¹⁷ Second, at the individual level, a person can be liable for torts or contracts of another individual within the organization.¹⁸ Incorporation covers these vulnerabilities with a corporate veil over the individual's assets, shielding them from an organization's creditors, and from liability for other individuals' actions.¹⁹ Benefits of incorporation include separate corporate existence, limited liability, the business judgment rule's protection, potential credit score and bankruptcy protection, intellectual

1913, and the unrelated business income rules arrived in 1950 ... [and] of the statutory law ... [came in] 1969. Hopkins, *Tax Exempt* (2015), xxix; Hopkins, *Nonprofit*, 169-184.

¹¹ K.S.A. §79-32, 113(a). V.A.M.S. §§355.001 et seq (nonprofit corporations); 352.010 et seq (pro forma/benevolent associations). See Louis, *Missouri Practice*, §35.1. The circuit court incorporated pro forma associations – e.g. City Union Mission and the Liberty Memorial - but pro forma members risked “personal liability” that a nonprofit corporation avoids. *Id.*

¹² See Hopkins, *Tax Exempt*, §2.1.

¹³ *Id.*

¹⁴ See Hopkins, *Tax Exempt*, §2.1; see Rosenthal, *Good Counsel*, xix.

¹⁵ See Hopkins, *Tax Exempt*, §4.1(a); see Hopkins, *Nonprofit*, 6.

¹⁶ Nobel laureate poet T.S. Eliot (1888-1965) wrote: “What we call the beginning is often the end/And to make an end is to make a beginning/The end is where we start from.” T.S. Eliot, *The Four Quartets*, “Little Gidding,” (No. 4), V.

¹⁷ K.S.A. §56a-306(a); V.A.M.S. §358.150.

¹⁸ K.S.A. §56a-305(a); V.A.M.S. §358.130.

¹⁹ Stephen B. Presser, *Piercing the Corporate Veil* (Thomson Reuters, 2019).

property ownership, perpetual life, and the ability to adapt to a changing mission over time.²⁰

Incorporating a nonprofit shields the organization's participants from the litigious aftermath of an unforeseen catastrophe.²¹ Pulitzer Prize winning author David McCullough tells the story of the fearsome Johnstown Flood of May 30, 1889 in Pennsylvania, which left 2,209 people dead and a town destroyed, and the savvy nonprofit planning that saved eminent businessmen like Andrew Carnegie, Henry Clay Frick, and Andrew Mellon from financial ruin.²² A *force majeure* can become any client's worst nightmare, but good counsel helps clients weather their darkest hours.²³

Tax Exempt Status

Tax exempt law is based on nonprofit corporations, but trusts and unincorporated associations can also qualify for tax exempt status.²⁴ Some nonprofits must be corporations (a federal government instrumentality or a title holding organization), some nonprofits must be trusts (supplemental unemployment benefit organizations, Black Lung benefit organizations, and multiemployer plan funds), but other nonprofits can be a corporation or trust (multi beneficiary title holding organization).²⁵ As Lesley Rosenthal of the Lincoln Center wrote, "nonprofits are of critical importance, providing nothing less than the foundation and fabric of a good [and] decent ... society."²⁶ More precedent exists for a tax exempt nonprofit corporation's corporate veil protection in extensive statutes, case law, and tax rules vis-à-vis an unincorporated nonprofit organization. Attorneys focus on obtaining the IRS' tax exempt blessing and for 501(c)(3)

²⁰ See Rosenthal, *Good Counsel*, 20-21; K.S.A. §17-6002(b)(6); see Martin, *Kansas Corporation Law*, §12.1.3.

²¹ Incorporation limits personal liability and mitigates risk using the 4 I's – (1) indemnification, (2) insurance, (3) immunity, and (4) incorporation. Hopkins, *Nonprofit*, 7-8, 313-318.

²² See David McCullough, *The Johnstown Flood* (Simon & Schuster, 2nd ed. 1987). The flood began when heavy rains breached an earthen dam at the South Fork Fishing and Hunting Club, on a mountain lakeshore 65 miles east of Pittsburgh. Chartered 15 November 1879, the Club was "the most exclusive resort in America." *Id.*, 249. The Club's incorporation allowed its members to weather a blizzard of lawsuits, protected its members with limited liability from the flood's devastating aftermath, although many Club members donated generously to relief efforts. *Id.*, 254-258.

²³ See Rosenthal, *Good Counsel*, 72.

²⁴ See Martin, *Kansas Corporation Law*, §12.1.4; see Louis, *Missouri Practice*, §35.4, at 168-171; see Hopkins, *Nonprofit*, 8-9 (corporations), 9-10 (trusts), 10-11 (associations); *Id.*, 65-78 (tax exempt status).

²⁵ See Hopkins, *Nonprofit*, 7.

²⁶ See Rosenthal, *Good Counsel*, 10-11.

organizations, to afford donors charitable income tax deductions for donations.²⁷ A donor may generously donate money to noble causes, but if the organization lacks the IRS tax exempt imprimatur, the donor will not receive any tax benefits or deductions for their generosity, and the recipient may realize taxable income or incur gift tax liability.²⁸

The tax exempt organization universe is a quirky blend of corporate and tax law. The corporate law waxes and wanes like a planet passing through the tax law's elegant orbit in the celestial nonprofit dance. 501(c)(3) charitable organizations afford donors tax deductible contributions but are bound by stricter rules, while the IRS Code recognizes dozens of other non-501(c)(3) organization types which have more flexibility but donors' contributions may not be tax deductible (as they are not charitable organizations), but the organizations are tax exempt.²⁹ A nonprofit must pass the organizational test to achieve tax exempt status.³⁰ To qualify for tax exempt status, legal formalities – including organizing documents, governing rules, and regularly chosen officers or leaders – must be followed.³¹ Tax exempt status gives organizations and donors privileges, but with a compliance cost and audit risk.³²

Tax exempt status contains two layers: (1) federal and (2) state.³³ For the first layer, the IRS grants federal tax exemptions for organizations engaged in charitable, educational, scientific, religious, or other similar activities and causes.³⁴ To obtain a tax exemption letter for a nonprofit client, the attorney files IRS Form 1023 requesting 501(c)(3) tax exempt status.³⁵ The operational test - does the organization operate in a charitable or nonprofit way? – illuminates if an organization should be tax exempt.³⁶ Closely related to the operational test is the primary purpose rule – the nonprofit must be

²⁷ See Hopkins, *Tax Exempt*, §§2.3, 4.2. See Phelan, *Nonprofit Organizations*, §1:3. See Rosenthal, *Good Counsel*, 28; Hopkins, *Nonprofit*, 129-146 (charitable giving rules).

²⁸ See Hopkins, *Tax Exempt*, §§2.3, §4.1(a) (“federal tax law makes no provision for a charitable deduction in ... personal ventures, however praiseworthy in character”).

²⁹ See Steven D. Simpson, *Tax Compliance for Tax Exempt Organizations* (CCH, 2019), §3.01; IRS Pub. 557, Form 1023.

³⁰ See Hopkins, *Tax Exempt*, §4.3.

³¹ See Hopkins, *Tax Exempt*, §4.1(a).

³² Hopkins, *Nonprofit*, 253-265 (watchdogs), 293-311 (audit).

³³ As discussed, “before an organization can be tax exempt, it must be a nonprofit organization.” Nonprofits are “creatures of state law,” while “tax exempt organizations” are “subjects of federal tax law.” Most states’ tax exemptions “follow the contours of the federal tax law.” Hopkins, *Nonprofit*, 6.

³⁴ Code §§ 501(a), (c)(3); see IRS Pub 557; see Phelan, *Nonprofit Organizations*, Ch. 2.

³⁵ See Martin, *Kansas Corporation Law*, §12.6.6; see Rosenthal, *Good Counsel*, 29, 44-45.

³⁶ See Hopkins, *Tax Exempt*, §4.5; see Webster, *Operation*.

primarily about a charitable purpose.³⁷ To keep tax exempt status, the nonprofit must make required public disclosures, avoid private inurement, and limit private benefit transactions.³⁸ Kansas and Missouri also offer tax exemption from state income, sales and use, and/or real and personal property taxes.³⁹

Most tax exempt organizations should incorporate. Nonprofit corporations have articles of incorporation, bylaws, and mission statements, while for profit corporations require articles of incorporation and bylaws. The nonprofit's mission statement is the pivot point.

Naming a Nonprofit Organization

A name illumines an individual or organization's character, quality, and reputation to the world.⁴⁰ Names can conjure up pleasant memories of days gone by or bitter defeats, communicate strength or weakness, fidelity or incompetence. First, check for name availability.⁴¹ The Kansas Secretary of State's website has a name and registered agent database for all Kansas nonprofits.⁴² A name is registered by filing paperwork or electronically with the Secretary of State, or a name is reserved for a nominal fee.⁴³ Beyond the state level, an attorney should check if (1) a proposed name is protected intellectual property, and (2) the domain name is available for the nonprofit's website.⁴⁴

³⁷ See Hopkins, *Tax Exempt*, §4.4.

³⁸ See Rosenthal, *Good Counsel*, 31-34; Hopkins, *Nonprofit*, 49-56, 56-57. By contrast, “[f]or profit organizations are *supposed* to engage in private inurement.” *Id.*, 5. Indeed, “a nonprofit entity ... differ[s] from a for profit corporation” since “it is barred from distributing its net earnings” “to individuals who ... control” the nonprofit.” *Id.*, 6. Sadly, nonprofits may succumb to insolvency's dark waters à la the Kansas City Club (1882-2015), the University Club (1886-2001), and Meadowbrook Country Club (1953-2014).

³⁹ See Rosenthal, *Good Counsel*, 30-31; K.S.A. §§79-32,113, 79-201 et seq. See Lacey, *Kansas Corporate Practice*, §18-4; see Martin, *Kansas Corporation Law*, §12.6; See Louis, *Missouri Practice*, §35.4, 170; see V.A.M.S. §§143.321, 143.441.2, 144.030.2, 137.100(5); Mo. Const., Art. X, §6; see Van Dyke, *Missouri Corporate Practice*, §§18-6, 18-8.

⁴⁰ See Hopkins, *Tax Exempt*, §4.8.

⁴¹ K.S.A. §§17-7918, 17-7919; see Martin, *Kansas Corporation Law*, §12.2.1.

⁴² See Kansas Charity Check website (www.kscharitycheck.org).

⁴³ K.S.A. §17-7923; see Kansas Secretary of State's website (<https://www.kansas.gov/businesscenter/>) and Missouri Secretary of State's website (sos.mo.gov/business/faqs.asp). Kansas charges a \$30 fee and allows a 120 day name reservation, K.S.A. §17-7923(b), while Missouri allows a 180 day name reservation.

⁴⁴ Federal trademark search at (www.uspto.gov). Kansas trademark search at (www.kssos.org/business/trademark/trademark_search.aspx); Missouri trademark search at (www.sos.mo.gov/business/trademark.asp). See Rosenthal, *Good Counsel*, 22, Ch.8.

Intellectual Property (IP)

Patents, copyrights, and trademarks are federal creatures.⁴⁵ Names cannot be patented or copyrighted, but a phrase could be trademarked as used continuously in the stream of commerce.⁴⁶ A logo, slogan, or expression may be protected by trademark, trade dress, or service mark.⁴⁷ IP law is a complex, specialized, and rapidly changing field. Federal, state, and international law provides various remedies and penalties for patent, copyright, or trademark infringement, and intellectual property owners enforce their portfolios with widely varying vigor. If a nonprofit has a lurking issue with a proposed name, logo, or content in this potential liability minefield, an IP attorney should be consulted about the nonprofit's IP portfolio.

Avoid choosing a name closely associated with a well known organization or prominent company or family name – e.g. Red Cross USA, the National Great War Museum, the Rockefeller Foundation, or the Wounded Warrior Foundation Inc. – as it may lead to litigation.⁴⁸ If the nonprofit organization will operate internationally, a trademark can be registered internationally under the Madrid Protocol and published in the WIPO Gazette of International Marks.⁴⁹ Googling a name is advisable, and a website domain name may be reserved for a nominal fee.

Incorporation Paradigms

Shifting gears to state corporate law dynamics, proper incorporation and compliance is vital for every nonprofit organization.⁵⁰ The attorney should maintain a copy of various key documents: articles of incorporation, mission statement, by laws, resolutions, minutes and board meeting records, tax filings, annual reports, government records, and other relevant legal documents (leases and property deeds, intellectual property documents, policies and procedures, and insurance policies).⁵¹ Throughout the nonprofit lifecycle, an

⁴⁵ See Rosenthal, *Good Counsel*, 81-88 (IP law), 91 (copyright), 185-221 (trademarks); see Kinney & Lange, *Intellectual Property for Business Lawyers* (2019); Lawrence M. Sung & Jeff E. Schwartz, *Patent Law Handbook* (2019); Paul Goldstein, *Goldstein on Copyright* (2019); William F. Patry, *Patry on Copyright* (2019); Bruce P. Keller & Jeffery P. Cunard, *Copyright Law* (2019); James E. Hawes & Bernard C. Dietz, *Copyright Registration Practice* (2019); Siegrun D. Kane, *Kane on Trademark Law* (2019).

⁴⁶ See Rosenthal, *Good Counsel*, 220-221; see Hopkins, *Tax Exempt*, §4.8.

⁴⁷ See Kinney & Lange, *Intellectual Property*, Ch. 8.

⁴⁸ K.S.A. §17-7918(b), (c); see Lacey, *Kansas Corporate Practice*, §5-4A.

⁴⁹ See Kinney & Lange, *Intellectual Property*, § 9:11.

⁵⁰ See Rosenthal, *Good Counsel*, 27, 44-45 (compliance); see Hopkins, *Tax Exempt*, §§4.2-4.3.

⁵¹ See Rosenthal, *Good Counsel*, 24, 257-269.

attorney should ask various questions and obtain documents. The attorney needs the articles of incorporation and by laws as well as the IRS tax exemption letter.⁵² The attorney should use a checklist or work plan to (1) familiarize herself with the organization’s mission, programs, and activities; (2) explore who the donors are and their interests in the organization; (3) develop a legal history or timeline of the organization; (4) examine whether new board members receive training or materials; (5) look at regulatory relationships; (6) ask if major leadership or governance changes could arise; (7) communicate about the organization’s expectations of the lawyer; (8) dialogue about the organization’s goals, visions, and desired outcomes; and (9) develop a detailed list of what legal work needs to be done and proactively communicate and work with the organization to accomplish the work.⁵³ Checklists are helpful tools to guide nonprofit counsel through the incorporation process, before we hone in on Kansas and Missouri’s nonprofit incorporation procedures.

*Practice Pointer – Nonprofit filing checklist*⁵⁴

- Incorporator’s Name and Mailing Address⁵⁵
- Corporate Name⁵⁶
 - Check Corporate Name Availability
 - State/federal trademark searches
 - Reserve Corporate Name (optional)
 - Protect Corporate Name (optional)
- Registered Office and Registered Agent⁵⁷

⁵² Kansas solemnizes filing a document with the Secretary of State under oath and penalty of perjury. K.S.A. §17-7909(a). In Kansas, a certified document copy “conclusively establishes” the document (1) has been filed and (2) is legally in force. K.S.A. §17-7938. In Missouri, a certified document is “conclusive evidence” that the original “is on file,” V.A.M.S. §355.046, but the Secretary’s “duty to file” is “ministerial,” so the certified presumption is weaker than Kansas (where the certification “conclusively establishes” the document to be enforceable). V.A.M.S. §355.036.4(1), (2), (3). Corrective filings are allowed. K.S.A. §17-7912. If a filing does not comply with the law, the Secretary will return the filing. K.S.A. §17-7913; V.A.M.S. §355.031. A court can order a party to sign a document if the party refuses. K.S.A. §17-7917. Fax or electronic filing is allowed. K.S.A. §17-7914. An attorney in fact may sign for a party. K.S.A. §17-7916. Knowingly signing a false document is a misdemeanor. V.A.M.S. §355.656.

⁵³ See Rosenthal, *Good Counsel*, 15-17.

⁵⁴ See Lacey, *Kansas Corporate Practice*, Form 5-5; Hopkins, *Nonprofit*, 11-12, 15-16.

⁵⁵ An “authorized officer” may execute documents for the nonprofit. K.S.A. §§17-6002(a)(5), 17-6003(b).

⁵⁶ K.S.A. §17-7504(a)(1); V.A.M.S. §§355.096.2(1), 355.146.

⁵⁷ K.S.A. §§17-7924, 17-7924(b), 17-7504(a)(2), 17-7925, 17-7902(a)(1), 17-7903(a)(2)(A). The registered agent can be served at the registered office. K.S.A. §§17-7915, 60-304. The registered agent or office can be changed or resign. K.S.A. §§17-7926, 17-7927, 17-7928, 17-7929; V.A.M.S. §355.161.

- Order Minute Book and Corporate Seal⁵⁸
- Draft contracts and policies for adoption by Board⁵⁹
- Tax exempt application/regulatory matters
- Federal Tax Identification Number (EIN) Application⁶⁰
- Incorporator’s Consent to Initial Board of Directors⁶¹
- 1st Consent of Directors
- Board of Director’s 1st Meeting⁶²
 - Agenda
 - Elect Officers
 - Adopt Bylaws⁶³
 - Approve bank account(s)
 - Ratify contracts and other drafted policies
 - Meeting Minutes⁶⁴
- Officers and governing body members⁶⁵
- Membership or capital stock shares issued, if any⁶⁶
- Subsidiary business owner?⁶⁷

⁵⁸ K.S.A. §§17-6514, 17-6102(3); V.A.M.S. §§355.431.2, 355.131(2).

⁵⁹ See Rosenthal, *Good Counsel*, Chs. 3-9, 11.

⁶⁰ Form SS-4 and IRS website; see Hopkins, *Nonprofit*, 22.

⁶¹ K.S.A. §§17-6007, 17-6301, 17-7908(a)(1); Martin, *Kansas Corporation Law*, §12.2.5; V.A.M.S. §355.111.

⁶² K.S.A. §17-6008; V.A.M.S. 355.111; Martin, *Kansas Corporation Law*, §12.2.6; Hopkins, *Nonprofit*, 16-18, 93-107. Kansas law lists the board’s powers (§17-6102) and gives the board powers “necessary or convenient to the conduct, promotion or attainment of the business or purposes” in the articles of incorporation. K.S.A. §17-6101(a).

⁶³ K.S.A. §17-6009; V.A.M.S. §355.116. The nonprofit’s by laws “may contain any provision” consistent with corporate law or the nonprofit’s articles of incorporation about (1) the nonprofit’s business, (2) conducting the nonprofit’s affairs, (3) the nonprofit’s rights or powers, or (4) the nonprofit’s stockholder’s, directors, officers, or employees rights of powers. K.S.A. §17-6009(b); V.A.M.S. §355.166. Emergency by laws can be adopted as needed. K.S.A. §17-6010; V.A.M.S. §355.121.

⁶⁴ See Martin, *Kansas Corporation Law*, §12.2.5 (provide for members’ rights of notice in bylaws); Hopkins, *Nonprofit*, 21-22.

⁶⁵ K.S.A. §17-7504(a)(3); V.A.M.S. §355.066(21); Hopkins, *Nonprofit*, 19-21.

⁶⁶ K.S.A. §§17-7504(a)(4), 17-6002(a)(4) (“The [capital stock] provisions ... shall not apply to [nonprofits] ... [the lack of capital stock] authority shall be stated in the articles of incorporation and ... the [nonprofit’s] directors ... shall be members ... The conditions of membership ... shall ... be stated in the articles of incorporation or ... the bylaws, and if a [nonprofit] corporation ... [has] authority to issue capital stock, [that authority] shall be stated in the articles of incorporation”); V.A.M.S. §§355.181.3, 335.191, 355.216; see Martin, *Kansas Corporation Law*, §12.1.2(b).

⁶⁷ K.S.A. §17-7504(a)(5); V.A.M.S. §355.131(16).

Kansas filing

Kansas accepts paper and electronic incorporation filings.⁶⁸ A Kansas charitable organization also files solicitation forms.⁶⁹ A Kansas nonprofit files an original and a copy of the articles of incorporation with the filing fee.⁷⁰ The Kansas nonprofit must file an annual report at the end of its tax year and a \$40 fee, change of registered office and/or agent and a \$20 fee, and other standard forms with the Kansas Secretary of State, just as a for profit corporation would.⁷¹

Missouri filing

Missouri's incorporation procedure is similar to Kansas.⁷² Missouri nonprofit corporations can file or efile.⁷³ Nonprofit corporations conducting business in Missouri must be designated as "public benefit" or "mutual benefit" corporations.⁷⁴ A Missouri nonprofit corporation must declare itself a public benefit corporation or a mutual benefit corporation in the articles of incorporation.⁷⁵ Public benefit corporations encompass several statutory categories, including religious or 501(c)(3) purposes, and are formed for the public good or to serve charitable goals, while mutual benefit corporations are the residual catch-all category and are focused on providing benefits to members, like a neighborhood association or social club.⁷⁶ A mutual benefit corporation's membership interests may be transferred or sold.⁷⁷ A Missouri nonprofit corporation's "corporate registration report" must be filed with the Secretary of State by August 31.⁷⁸

⁶⁸ The "effective date" is the "filing date," which could have tax impacts. K.S.A. §17-7911.

⁶⁹ K.S.A. §17-1763; see Rosenthal, *Good Counsel*, Ch. 5.

⁷⁰ K.S.A. §§17-7504, 17-6004.

⁷¹ See the Kansas Secretary's website www.accesskansas.org/annual-reports/index.do. K.S.A. §§17-7504, 17-7910, 17-6204; see Phelan, *Nonprofit Law*, §2:27.

⁷² See Louis, *Missouri Practice*, §35.5.

⁷³ Missouri nonprofits do not distribute income or property to members, directors, or officers. *Osage Water Co. v. Miller County Water Authority, Inc.*, 950 S.W.2d 569 (Mo. App. S.D.1997). See the Missouri Secretary's website (<http://www.sos.mo.gov/business/corporations/startBusiness.asp>).

⁷⁴ V.A.M.S. §355.881(1). Missouri carves out three public benefit corporation types – (1) religious corporations (§355.881(2)), (2) alternate 501(c)(3)s (§355.881(3)), and (3) corporations with a "public charitable purpose" - while the rest are mutual benefit corporations. V.A.M.S. §355.881(2)-(5).

⁷⁵ V.A.M.S. §355.096.2(2)(a), (b).

⁷⁶ V.A.M.S. §§355.066(23), 355.066(28), 355.881. See Van Dyke, *Missouri Corporate Practice*, §18-1.

⁷⁷ V.A.M.S. §355.691.1(7); see Van Dyke, *Missouri Corporate Practice*, §18-1.

⁷⁸ V.A.M.S. §355.856.3; see Van Dyke, *Missouri Corporate Practice*, §18-17. A Missouri nonprofit that fails to file a corporate registration report must pay a \$15 fee or dissolve. V.A.M.S. §§355.856.3, 355.706. The corporate registration report is due August 31 of the year after incorporation, and the corporation must continue filing corporate registration reports by August 31 of each succeeding year. See Van Dyke, *Missouri Corporate Practice*, §18-17.

II. Articles of Incorporation

Two threads course through every nonprofit organization's tapestry: [1] "a creating document (articles of incorporation) and [2] a document containing operational rules (bylaws)."⁷⁹ Articles of incorporation give birth to a nonprofit corporation, so the first breaths of incorporation are crucial.⁸⁰ Nonprofit articles of incorporation must include certain elements and be filed with the state Secretary of State's office.⁸¹ The nonprofit's counselor should also file for any necessary state regulatory permits for the client.⁸² Sample articles of incorporation are included in Exhibit A.⁸³

Kansas and Missouri have similar nonprofit incorporation laws. But Missouri law requires the articles of incorporation to (1) designate the nonprofit as a public or mutual benefit corporation and to (2) explain how the nonprofit's assets are to be distributed upon distribution.⁸⁴ While the second distinction is not expressly in Kansas law, it is required by the IRS before approving a nonprofit's tax exempt status.⁸⁵

➤ *Kansas Practice Pointer – Necessary provisions:*

- The corporation's name
- The registered office's address and resident agent's name
- A general or specific statement of the corporation's purposes
- Each incorporator's name and address
- Initial directors' names and addresses.⁸⁶
- Asset distribution framework upon dissolution.

➤ *Missouri Practice Pointer – Necessary provisions:*

- The corporation's name
- Public or mutual benefit corporation
- The registered office's address and resident agent's name

⁷⁹ Hopkins, *Nonprofit*, 6.

⁸⁰ K.S.A. §17-6006; V.A.M.S. §§355.066(2), 355.096; 355.191; see Hopkins, *Tax Exempt*, §4.2; see Rosenthal, *Good Counsel*, 22; see Phelan, *Nonprofit Organizations*, §§ 1:12-1:18; see Lacey, *Kansas Corporate Law*, Ch. 6; see Van Dyke, *Missouri Corporate Practice*, §18-3.

⁸¹ K.S.A. §§17-6002(a), 17-6005; V.A.M.S. §§355.096.2 (mandatory - "must set forth"), 355.096.3 (optional - "may set forth").

⁸² See Rosenthal, *Good Counsel*, 23.

⁸³ See Martin, *Kansas Corporation Law*, Apps. 12A and 12B.

⁸⁴ K.S.A. §17-6805a; see Martin, *Kansas Corporation Law*, §12.2.2.

⁸⁵ See Martin, *Kansas Corporation Law*, §12.2.2 (no asset distribution plans could harm tax exempt status).

⁸⁶ K.S.A. §17-6002(a)(6). See Lacey, *Kansas Corporate Law*, §6-2; see Martin, *Kansas Corporation Law*, §12.2.2.

- Each incorporator’s address
- Corporation’s members, if any
- Asset distribution framework upon dissolution.⁸⁷

a. Governing Body

The board of directors governs a nonprofit.⁸⁸ The board of directors manage the nonprofit’s activities and possess similar powers to a for profit corporation’s board of directors, except that a nonprofit’s board of directors may not engage in activities that would jeopardize the nonprofit’s tax exempt status with state and federal governments.⁸⁹ The articles of incorporation or bylaws may contain provisions electing options on certain nonprofit management issues; otherwise state corporate law applies by default.⁹⁰ Board members have state law fiduciary duties of care, loyalty, and obedience to uphold.⁹¹ Board independence is a “hallmark of good nonprofit governance” for the IRS.⁹² Boards should not be “too small, too insular, or too deferential” to the nonprofit’s leader. Board members should be selected based on “ability and availability to fulfill fiduciary duties, providing the critical oversight function. Board attention is crucial to good governance.”⁹³ Board members should receive a handbook of materials including key organizational documents, policies, and procedures.⁹⁴

The nonprofit board of directors has many responsibilities, including: (1) determine mission and purposes, (2) select the chief executive, (3) support and evaluate the chief executive, (4) ensure effective planning, (5) monitor and strengthen programs and services, (6) ensure adequate financial resources, (7) protect assets and provide financial oversight, (8) build a competent board, (9) ensure legal and ethical integrity, and

⁸⁷ See V.A.M.S §355.025; see Louis, *Missouri Practice*, §35.7; see Fast, *Missouri Practice*, §§48.11, 48.13.

⁸⁸ K.S.A. §17-6301; V.A.M.S. §355.316.1 et seq.; see Hopkins, *Nonprofit Boards*; see Lacey, *Kansas Corporate Law*, §18-8; see Van Dyke, *Missouri Corporate Practice*, §18-11; see Hopkins, *Tax Exempt*, Ch. 5; see Louis, *Missouri Practice*, §35.6 (Missouri requires at least 3 directors, V.A.M.S §355.321.2); see Fast, *Missouri Practice*, §§48.2.

⁸⁹ V.A.M.S. §355.131; see Van Dyke, *Missouri Corporate Practice*, §§18-9, 18-11; see Hopkins, *Tax Exempt*, §5.4.

⁹⁰ See Lacey, *Kansas Corporate Law*, §6-4; see Louis, *Missouri Practice*, §35.26.

⁹¹ See Rosenthal, *Good Counsel*, 8, 9 (fiduciary duty); see Martin, *Kansas Corporation Law*, §12.2.9 (*Burcham v. Union Bancorp, Inc.*, 276 Kan. 393 (2003) (duty of care and business judgment rule), *Becker v. Knoll*, 40 Kan. App.2d 1049, 1053 (2008) (duty of loyalty and its corollary, self dealing, prohibited)).

⁹² See Rosenthal, *Good Counsel*, 34.

⁹³ See Rosenthal, *Good Counsel*, 60.

⁹⁴ See Rosenthal, *Good Counsel*, 49-50.

(10) enhance the organization’s public standing.⁹⁵ Adopting best practices will improve a nonprofit’s governance.⁹⁶ Corporate governance is a focal point of the public eye as activist investors, boards, officers, executives, and influential people and groups across society push for increased corporate responsibility, shareholder democratization, and other changes to corporations.⁹⁷ Suffice to say, we “live in an era of heightened awareness” about “nonprofit governance.”⁹⁸

b. Purpose Clause

The purpose clause or mission statement is crucial to the articles of incorporation as it establishes what the nonprofit will do.⁹⁹ Missouri provides a non-exclusive list of nonprofit purposes.¹⁰⁰ The purpose clause should be carefully tailored to satisfy the IRS’ primary purpose test – is the corporation’s primary purpose charitable or nonprofit? – and the purpose clause should be refined as needed to withstand IRS scrutiny.¹⁰¹

Here is a sample purpose clause or mission statement:

The Corporation is organized exclusively for charitable, religious, educational and scientific purposes within the meaning of Code Sections 501(c)(3), 170(c)(2)(B), 2055(a)(2) and 2522(a)(2), including for those purposes and the making of distributions to organizations that qualify as exempt organizations under Code Section 501(a) by reason of Code Section 501(c)(3). The Corporation’s purposes shall include, but not be limited to, _____ . To enable the Corporation to carry out its purposes, it shall have the power to do any and all lawful acts and to engage in any and all lawful activities, directly or indirectly, alone or in conjunction with others, which may be necessary, proper or suitable for the attainment of any of the Corporation’s purposes.¹⁰²

As the corporate lawyer peers through the nonprofit incorporation lens, the purpose clause’s importance comes into sharp focus. For profit corporations have broad latitude and minimal corporate law boundaries and may override some default provisions with specific language in the organic documents. By contrast, a nonprofit corporation’s purpose statement curbs the corporate law latitude and often prescribes activities which fit within the four corners of Code §501(c)(3)’s “charitable, religious, educational and

⁹⁵ See Hopkins, *Tax Exempt*, §5.6.

⁹⁶ See Louis, *Missouri Practice*, §35.8; see Hopkins, *Tax Exempt*, §5.7(e).

⁹⁷ See Rosenthal, *Good Counsel*, 62-63.

⁹⁸ See William Quick & Amy Abrams, “Disclosure Obligations,” 79-Mar J.K.B.A. 20, 21.

⁹⁹ See Rosenthal, *Good Counsel*, 7; Fast, *Missouri Practice*, §48.21 et seq.; Hopkins, *Tax Exempt*, §4.3(a).

¹⁰⁰ V.A.M.S. §355.025;

¹⁰¹ See Hopkins, *Tax Exempt*, §4.4; see Simpson, *Tax*, §3.05.

¹⁰² See Exhibit A, “Article III – Objects and Purposes.”

scientific purposes” to qualify for tax exempt status. Practitioners and nonprofit incorporators should devote ample time to crafting a purpose statement to ensure tax exempt status is awarded and to help focus the nonprofit participants on what its goals, ends, and aims will be.

c. Dissolution Clause

Like diamonds, corporations are forever, but a specific nonprofit rationale could be achieved or become obsolete. A wise attorney will anticipate dissolution in the articles of incorporation.¹⁰³ Dissolution can involve a sale of assets and be voluntary or (involuntary) court ordered.¹⁰⁴ When will the nonprofit corporation dissolve? Under what circumstances? Who decides? What if the nonprofit’s goals are achieved? What if the nonprofit’s mission becomes illegal or irrelevant? A well crafted dissolution clause in the nonprofit’s articles of incorporation will answer these and other questions, and is vital to achieving tax exempt status.¹⁰⁵

A trust law story provides illumination when contemplating changes in nonprofit purposes and drafting dissolution clauses. Arthur Mag (1896-1981) was a legendary Kansas City corporate and trust attorney and founding partner of what is now Stinson LLP (formerly Stinson, Mag & Fizzell PC), whom, among other distinguished work, served as the attorney for numerous charitable trusts established by prominent Kansas Citians in the early 20th century.¹⁰⁶ At the time, trust law did not allow charitable trust reformation, even if the trust’s purposes had become obsolete (a disease cure discovered or the Alf Landon for President Campaign of 1936 fizzled) or illegal. Mr. Mag and his associates blazed trust law trails for generations of corporate and trust attorneys, and received vindication of charitable trust reformation from Missouri’s federal courts.¹⁰⁷ This local angle on the creation of modern charitable trust law illustrates the importance

¹⁰³ See Hopkins, *Tax Exempt*, §4.3(b).

¹⁰⁴ Phelan, *Nonprofit Organizations*, §7:5; *id.*, §§7:6-7:9; see Simpson, *Tax*, §3.06.

¹⁰⁵ K.S.A. §§17-6801 et seq., 17-6805a; see Martin, *Kansas Corporation Law*, §§12.5, 12.2.2; V.A.M.S. §355.666 et seq.; see Louis, *Missouri Practice*, §35.16; see Fast, *Missouri Practice*, §48:81.

¹⁰⁶ See Donald H. Chisholm, “The Philanthropic Philosophy of Arthur Mag” (1998), at <http://shs.umsystem.edu/kansascity/kimball/Chisholm-10-21-1998.pdf>. On Arthur Mag, see: “Arthur Mag’s Good Life,” *KC Times*, 10/26/1981, A12; “Arthur Mag services Tuesday,” *KC Star*, 10/25/1981, 92A; “Longtime KC civic leader,” *KC Times*, 10/24/1981, B1; “Mag: Legal Talents Open Many Doors,” *KC Star*, 7/2/1975, A11; and “In Mag They Entrust,” *KC Star*, 4/6/1975, A19.

¹⁰⁷ See *Irwin v. Swinney*, 45 F.2d 890 (W.D. Mo. 1930), *Gossett v. Swinney*, 53 F.2d 772 (8th Cir. 1931) (approving Mag’s novel charitable trust in the Will of Harry Loose (1876-1927)).

of careful drafting and planning when working with tax exempt organizations, as the practitioner's work needs to be adaptable enough to endure the test of time.

A Kansas nonprofit corporation's dissolution clause should include the following or similar language:

Upon the corporation's dissolution, the corporation's board of directors or governing body, after paying or providing for the payment of all the corporation's liabilities, shall dispose of all the corporation's assets exclusively: (1) According to the corporation's purposes, in the manner determined by the board of directors or governing body, or (2) to organizations qualified for exemption under Code Section 501(c)(3), and specified by the board of directors or governing body. Any corporation assets not so disposed of shall be disposed of by the district court of the county where the corporation's principal office is then located, exclusively for the purposes or to the organizations provided above, as determined by the court.¹⁰⁸

Missouri has certain requirements to dissolve a nonprofit corporation.¹⁰⁹ A dissolving Missouri public benefit nonprofit corporation may distribute its remaining assets to one or more public benefit nonprofit corporations or foreign nonprofit corporations, if the articles of incorporation are silent on point.¹¹⁰ A dissolving Missouri mutual benefit nonprofit corporation may distribute its remaining assets to its members, or if it has no members, to those who it holds itself out as serving, if the articles of incorporation are silent on point.¹¹¹ A dissolving Missouri public benefit nonprofit corporation must notify the Missouri Attorney General's office in writing of its asset distribution plans.¹¹²

d. Required IRS Provisions

The IRS requires two sets of provisions. First, a nonprofit corporation must state its nonprofit, educational, religious, scientific, or other charitable objectives.¹¹³ Second, the corporation's activities must be constrained within its nonprofit boundaries to maintain its tax exempt status.¹¹⁴ The IRS requires two disclosures from nonprofits: first, the organization's IRS application for exemption on Form 1023 or 1024, and second, the

¹⁰⁸ K.S.A. §17-6805a.

¹⁰⁹ V.A.M.S. §355.676.

¹¹⁰ V.A.M.S. §355.691.1(6); *DeBaliviere Place v. Veal*, 337 S.W.3d 670 (Mo. 2011) (no closing deadline).

¹¹¹ V.A.M.S. §355.691.1(7).

¹¹² V.A.M.S. §355.676(1).

¹¹³ See Hopkins, *Tax Exempt*, §4.3(a); see Simpson, *Tax*, §3.03.

¹¹⁴ See Lacey, *Kansas Corporate Law*, §18-7; Simpson, *Tax*, §3.04; Louis, *Missouri Practice*, §35.6.

nonprofit's 3 most recent Forms 990.¹¹⁵ Importantly, a Missouri mutual benefit nonprofit corporation does not automatically qualify for IRS tax exempt status upon proper formation under Missouri law, because a mutual benefit corporation's activities may cross nonprofit boundaries and turn a profit.¹¹⁶

e. Other Crucial Language

In our modern litigious environment, a nonprofit corporation should have several policies in place. These policies may include a compensation policy, a whistleblower policy, a document retention and destruction policy, a travel and other expense reimbursement policy, a gift acceptance policy, a joint venture policy, a conflict of interest policy or a conflicts of interest and documentation policy, interested party transactions, policies adopted by an interested party transaction committee, a media relations policy, and noncompete covenants.¹¹⁷ These various policies may be adapted as needed for a nonprofit corporation's unique size, complexity, activities, and composition, and may be separate standing policies duly adopted by the Board of Directors, or integrated as clauses in the By-Laws. Directors, officers, and employees should confirm in writing receipt, review, and compliance with the nonprofit's policies.¹¹⁸ These policies are best practices for nonprofit corporations and will help directors, officers, employees, professional advisors, volunteers, and donors by clarifying the nonprofit corporation's position on various issues and what activities are or are not appropriate for those

¹¹⁵ See Quick & Abrams ("various record disclosures" is a best practice, but the IRS needs "few").

¹¹⁶ See Van Dyke, *Missouri Corporate Practice*, §18-4.

¹¹⁷ See *id.*, Forms 18-4 (compensation), 18-5 (whistleblower), 18-6 (record retention) (cf. Rosenthal, *Good Counsel*, 40 and see IRS Publication 583), 18-7 (travel and expense reimbursement), 8-8 (gifts) (cf. Rosenthal, *Good Counsel*, 40-41), 18-9 (joint venture) (cf. Rosenthal, *Good Counsel*, 41-43), 18-12 or 18-15 (conflicts of interest) (cf. Rosenthal, *Good Counsel*, 36-38, and IRS sample (www.irs.gov/instructions/i1023/ar03.html), 18-12A (Missouri conflicts of interest and documentation); see Martin, *Kansas Corporation Law*, §12.3.10. see Rosenthal, *Good Counsel*, 35-36; see Lacey, *Kansas Corporate Law*, Form 18-5 (Kansas conflicts of interest); see *id.*, Form 18-8 (Kansas conflicts of interest and documentation); Hopkins, *Tax Exempt*, §5.6(f)(iii), (iv); see Martin, *Kansas Corporation Law*, §§12.2.9 and 12.2.10 (conflicts of interest); see Van Dyke, *Missouri Corporate Practice*, Form 18-13 (Missouri interested party transactions); Lacey, *Kansas Corporate Law and Practice*, Form 18-6 (Kansas interested party bylaw); see Van Dyke, *Missouri Corporate Practice*, Form 18-14 (Missouri interested party committee); Lacey, *Kansas Corporate Law and Practice*, Form 18-7 (Kansas interested party committee); see Rosenthal, *Good Counsel*, 38-40 (whistleblower policy) and 50 (media relations policy); see *Healthcare Services v. Copeland*, 198 S.W.3d 604, 614 (Mo. 2006) (nonprofits can protect themselves from unfair competition just like for profits), quoted in Brian M. Malsberger, *Covenants Not to Compete* (Bloomberg BNA, 2018), 2:3255 (Kansas law silent on point).

¹¹⁸ See Rosenthal, *Good Counsel*, 37, 44-45.

interacting with the nonprofit corporation.¹¹⁹ Given the diverse nature of nonprofit organizations, use discretion to determine which policies and procedures are best practices for a particular organization and the precise contours of those policies.

IV. Bylaws

If the articles of incorporation are the nonprofit corporation's life breath, the Bylaws are the nonprofit corporation's DNA, laying out the nonprofit's activity blueprint and organizational tapestry.¹²⁰ Nonprofit bylaws may contain any provision consistent with the articles of incorporation.¹²¹ A nonprofit corporation must file Bylaws with the state Secretary of State's office.¹²² Sample nonprofit corporation Bylaws may be found in a corporate law treatise.¹²³

a. Directors and Officers

The board of directors and officers oversee and run the nonprofit corporation, so their composition, authority, and actions determine the organization's pulse.¹²⁴ A wise corporate counsel will advise directors and officers to adopt nonprofit best practices.¹²⁵ How are directors and officers of the nonprofit corporation to be selected?¹²⁶ How long will their terms of service last?¹²⁷ What procedures are to be followed in selecting their replacements or successors? May a director or officer be removed?¹²⁸ May a director or

¹¹⁹ See Hopkins, *Tax Exempt*, §5.3; see Fast, *Missouri Practice*, §48.2.

¹²⁰ See Phelan, *Representing Nonprofit Organizations*, §1:19; see Hopkins, *Tax Exempt*, §4.2; see Rosenthal, *Good Counsel*, 23-24.

¹²¹ V.A.M.S. §355.116. See Fast, *Missouri Practice*, §48.32; see also *Boatman's First Nat'l Bank of West Plains v. Southern Missouri Dist. Council of the Assemblies of God*, 806 S.W.2d 706 (Mo App. S.D. 1991) and *Missouri State Teacher's Ass'n v. St. Louis Suburban Teachers Ass'n*, 622 S.W.2d 745 (Mo App. E.D. 1981).

¹²² K.S.A. §17-6009; V.A.M.S. §355.116; see Lacey, *Kansas Corporate Law*, §18-7; see Van Dyke, *Missouri Corporate Practice*, §18-10.

¹²³ See Lacey, *Kansas Corporate Law*, Ch. 11; see Martin, *Kansas Corporation Law*, §12.2.3; see Van Dyke, *Missouri Corporate Practice*, Forms 11-2 (members bylaws) and 11-3 (no members bylaws); see Louis, *Missouri Practice*, §35.12. Kansas' corporate law landscape follows Delaware law, while Missouri corporate law contours follow Illinois law and the Model Business Corporation Act.

¹²⁴ See Hopkins, *Tax Exempt*, Ch. 5; see Van Dyke, *Missouri Corporate Practice*, §18-11; see Louis, *Missouri Practice*, §35.6; see Martin, *Kansas Corporation Law*, §§12.2.8, 12.2.9.

¹²⁵ See Rosenthal, *Good Counsel*.

¹²⁶ K.S.A. §§17-6301(a), (b), (c), (d), 17-6501(f). See Quick, 73-Aug J.K.B.A. 30, 35-36. V.A.M.S. §§ 355.301, 355.321, 355.326.

¹²⁷ V.A.M.S. §§355.331 (1 year default term; non-designated/appointed directors serve up to 6 years), 355.336 (staggered terms).

¹²⁸ See Martin, *Kansas Corporation Law*, §12.3.11; K.S.A. §17-6301(k) (removal) and see Quick, 73-Aug J.K.B.A. 30, 33-34. K.S.A. §§17-6513(a) and (d). V.A.M.S. §§ 355.341 (resignation), 355.346 (removal), 355.351 (removal by articles of incorporation or bylaws amendment), 355.356 (removal by court).

officer resign?¹²⁹ What, if any, compensation will a director or officer receive for his or her service to the nonprofit corporation?¹³⁰ And if a vacancy arises?¹³¹ Will the board of directors include committees?¹³²

The bylaws should have or reference a conflict of interest policy, especially for interested party transactions involving directors or officers.¹³³ As with for profit corporations, a nonprofit corporation's director or officer may be involved with an outside entity that conducts business with or provides services to the nonprofit. Interested party transactions are not per se prohibited, but must be conducted transparently, with accountability to the board of directors and the members, and not be preferential or self dealing transactions.¹³⁴

b. Meetings

Every corporation, whether for profit or nonprofit, must have regular meetings.¹³⁵ The attorney should counsel her nonprofit client that "taking minutes is an art" and minutes "are not private to board members."¹³⁶ A nonprofit's meetings may be subject to the Kansas Open Meetings Act.¹³⁷ The board of directors must meet and keep minutes.¹³⁸ The shareholders of a for profit corporation, or the members of a nonprofit corporation, must also have at least annual meetings to discuss and vote on the corporation's business affairs, director, and officer elections, and the like. When will those meetings be held? What procedures will be used for providing notice of the meetings to members of the nonprofit corporation? Who will keep minutes of the meetings?¹³⁹ In what form, or where will those meeting minutes be kept?¹⁴⁰

¹²⁹ See note ___ about resignations. K.S.A. §17-6302(b).

¹³⁰ K.S.A. §17-6301(h). See Quick 73-Aug J.K.B.A. 30, 33. V.A.M.S. §355.366 (no director compensation unless articles or bylaws allow); see Van Dyke, *Missouri Corporate Practice*, Form 18-4.

¹³¹ K.S.A. §§17-6302(e), 17-6513.V.A.M.S. §355.361.

¹³² K.S.A. §17-6301(c)(3) and see Quick 73-Aug J.K.B.A. 30, 33.

¹³³ See e.g. Louis, *Missouri Practice*, §35.27; see also ante note 101.

¹³⁴ See Lacey, *Kansas Corporate Law*, §18-16; see Van Dyke, *Missouri Corporate Practice*, Form 18-13. See Exhibit D (conflict of interest and interested party transaction policy). See also Exhibit B, ¶6.10.

¹³⁵ K.S.A. §§17-6301(f) and (g). See also Quick, 73-Aug J.K.B.A. 30, 35-36. V.A.M.S. §355.376. See Louis, *Missouri Practice*, §35.9; see Fast, *Missouri Practice*, 48:51; see Hopkins, *Tax Exempt*, §5.6(a).

¹³⁶ See Rosenthal, *Good Counsel*, 50-52.

¹³⁷ K.S.A. §75-4318 and see Quick and Abrams, 79-Mar J.K.B.A. 20, 22-24. Missouri's sunshine law does not appear to apply to nonprofit organizations. V.A.M.S. §610.010 et seq.

¹³⁸ See Phelan, *Nonprofit Organizations*, §§1:18, 1:20. V.A.M.S. §355.431.2; see Fast, *Missouri Practice*, 48:41.

¹³⁹ V.A.M.S. §355.431.2; K.S.A. §17-6302(a); see Martin, *Kansas Corporation Law*, §12.2.7(c).

¹⁴⁰ K.S.A. §17-6514.

c. Voting

What constitutes a quorum of members?¹⁴¹ Must voting be done in person? Are proxy votes by mail, phone, or electronically (via email, text, Internet, video conference, or virtual meeting software) permissible?¹⁴² What form of proxy voting is allowed?¹⁴³ How are proxy votes authenticated?¹⁴⁴ Do all members receive one vote, or do some members receive super voting powers? How are voting rights determined and regulated?¹⁴⁵ Is cumulative voting allowed?¹⁴⁶ Does a majority carry the day on a motion, or is a super majority required? Are voting trusts allowed, and if so, what parameters apply? Who collects and tabulates the votes? What if there is a dispute about the vote count? If the vote is close, is an automatic or optional recount allowed?

d. Indemnification

Everyone involved in a nonprofit organization, from the directors, to the officers, to the members, and even the donors and volunteers needs some indemnification consideration.¹⁴⁷ Attorney fees and other expenses may be advanced or paid for directors and officers.¹⁴⁸ Directors and officers will seek indemnity for their actions on behalf of the nonprofit corporation just as for profit corporation directors and officers seek indemnity.¹⁴⁹ They may desire director and officer's (D&O) insurance if it is available.¹⁵⁰ Members need indemnification if directors or officers make a mistake that disrupts the nonprofit's tax exempt status.¹⁵¹ Volunteer directors and officers and donors may qualify for financial and/or activity indemnification in Kansas and Missouri.¹⁵² The corporation's

¹⁴¹ K.S.A. §17-6505(c); see Quick, 73-Aug J.K.B.A. 30, 31-32 ("members in attendance ... constitute a quorum"); Martin, *Kansas Corporation Law*, §12.2.7(e). V.A.M.S. §355.401.

¹⁴² K.S.A. §17-6301(i). V.A.M.S. §355.291.

¹⁴³ K.S.A. §17-6505(b) (3 year default proxy voting term); see Quick, 73-Aug J.K.B.A. 30, 36.

¹⁴⁴ K.S.A. §17-6501(a)(2).

¹⁴⁵ K.S.A. §§17-6502(a) and 17-6504. V.A.M.S. §355.276.1.

¹⁴⁶ K.S.A. §17-6504.

¹⁴⁷ See Phelan, *Nonprofit Organizations*, §§1:28-1:45; see Rosenthal, *Good Counsel*, 73. K.S.A. §17-6305 and see Quick, 73-Aug J.K.B.A. 30, 34. V.A.M.S. §§355.471, 355.476.

¹⁴⁸ K.S.A. §17-6305; see Quick, 73-Aug J.K.B.A. 30, 34.

¹⁴⁹ K.S.A. §17-6305; V.A.M.S. §§355.461(1), (2); see Hopkins, *Tax Exempt*, § 5.4.

¹⁵⁰ K.S.A. §17-6305(g); V.A.M.S. §355.496; see Hopkins, *Tax Exempt*, § 5.4.

¹⁵¹ Missouri nonprofit members are not personally liable for the nonprofit's debts, V.A.M.S. §355.197, but a member is liable for unpaid capital contributions or membership dues, and to the nonprofit's creditors. See Van Dyke, *Missouri Corporate Practice*, §18-13.

¹⁵² K.S.A. §60-3601; see Martin, *Kansas Corporation Law*, §12.2.9; see Louis, *Missouri Practice*, §35.8.

articles of incorporation or by laws may contain indemnification and advancing expenses to directors.¹⁵³

V. Mission Statement

A nonprofit corporation's mission statement is crucial: both to obtain and maintain tax exempt status as an organization from the IRS, and to maintain similar tax exempt status from the state.¹⁵⁴ An attorney advising a nonprofit organization should take care to ensure that the organization's mission statement clearly states its nonprofit goals with reference to the traditionally recognized nonprofit purposes: educational, religious, charitable, scientific, etc.¹⁵⁵ IRS Form 990 has been redesigned to emphasize a nonprofit organization's mission statement, especially for public charities, so a mission statement is becoming increasingly important in the nonprofit incorporation process.¹⁵⁶ While a purpose clause needs to be included in the nonprofit's organic documents, a mission statement may take considerably more time to formulate, and can be added some months later.

The mission statement focuses on the organization's nonprofit goals and charitable and educational purposes. It then expounds how these goals and purposes are to be achieved – by providing educational and informational resources to parents and children regarding the dangers of abduction, as well as resources to help locate and protect a child who has been abducted. It specifies these resources will be delivered in a variety of formats and media, and the target audience for the resources.

VI. *The Use of LLCs (and L3Cs) for Nonprofits*

Nonprofits have incorporated for 100 years to achieve tax exempt status. But as the corporate law world has moved from corporations to limited liability companies (LLCs) and innovative hybrid entities, how should corporate lawyers apply these innovations to nonprofit organizations? Can a limited liability company and/or a low profit limited

¹⁵³ K.S.A. §17-6305; V.A.M.S. §355.501.

¹⁵⁴ V.A.M.S. §355.025; see Rosenthal, *Good Counsel*, 28-34; see Hopkins, *Tax Exempt*, §4.3(c).

¹⁵⁵ See Hopkins, *Tax Exempt*, §4.3(a). The IRS website is helpful (<https://www.stayexempt.irs.gov>).

¹⁵⁶ See *id.*, §4.3(c); see Rosenthal, *Good Counsel*, 134-135; Hopkins, *Nonprofit*, 109-117.

liability company be a nonprofit? Yes.¹⁵⁷ Kansas law might allow an existing nonprofit corporation to convert to an LLC, but careful compliance with IRS rules is required.¹⁵⁸

a. Nonprofit LLCs

Limited liability companies (LLCs) are an integral tool in the corporate lawyer's repertoire.¹⁵⁹ Like corporations and partnerships, LLCs are creatures of state law.¹⁶⁰ An LLC with two or more charitable or governmental members can be a tax exempt charitable organization if it meets 12 conditions specified by the IRS.¹⁶¹ LLCs have become "the vehicle of choice" for joint ventures among tax exempt organizations.¹⁶²

b. Nonprofit L3Cs

If LLCs are a fresh, but reliable, player in the corporate law landscape, L3Cs are the rookies making their debut.¹⁶³ An L3C (low-profit limited liability company) is a hybrid for profit LLC and tax exempt organization.¹⁶⁴ An L3C is a type of LLC whose business purpose is to take donations from private foundations and spend those monies as a qualifying program related investment under the IRS Code.¹⁶⁵ The nonprofit practitioner should be aware of L3Cs, while realizing that L3Cs are "only meaningful to a fairly narrow universe of LLCs" and even if an L3C is desirable, the IRS' verdict is still out, so there is a greater level of risk for an organization, its participants, and its donors to become an L3C.¹⁶⁶ L3Cs have program related investments (PRIs) that may be run by for profit organizations.¹⁶⁷ It has a charitable purpose, but it may also produce income along the way.¹⁶⁸ An L3C may qualify for tax exempt status if its members are solely

¹⁵⁷ See Cassady V. Brewer, Elizabeth C. Minnigh & Robert A. Wexler, *Social Enterprise by Non Profits and Hybrid Organizations* (Bloomberg BNA No. 489, 2014); see Hopkins, *Tax Exempt*, §4.12.

¹⁵⁸ K.S.A. §§17-78-101 et seq, 17-7904(a), 17-7920, 17-7930, 17-7931, 17-7932, 17-7933, 17-7934, 17-7935, 17-7936. See Edwin W. Hecker, Jr., *The Kansas Business Entity Transactions Act*, 80 J. Kan. B.A. 8 (Sept. 2011). V.A.M.S. §347.700 et seq.

¹⁵⁹ See Stephen M. Bainbridge, *Agency, Partnerships & LLCs* (3rd ed., 2018), Ch. 4, and *Corporate Law* (3rd ed., 2015). For Kansas LLC law's contours, see Hecker, *The Kansas Revised Limited Liability Company Act*, 69 J. Kan. B.A. 16 (Nov./Dec. 2000).

¹⁶⁰ See K.S.A. §17-7662 et seq.; V.A.M.S. §347.010 et seq.

¹⁶¹ See Nicholas G. Karambelas, *Limited Liability Companies* (2019), §6:26. See Hopkins, *Tax Exempt*, §4.3(e); see Karambelas, *LLC*, §6:26; see PLR 201022029 (individual member fails organizational test); McCray & Thomas, *LLCs* (<https://www.irs.gov/pub/irs-tege/eotopicb01.pdf>); Webster, *Organization*, A-9.

¹⁶² See Hopkins, *Tax Exempt*, §§32.5-32.7; see Hopkins, *Nonprofit*, 57-58, 223-232.

¹⁶³ See Hopkins, *Tax Exempt*, §4.12(c).

¹⁶⁴ See Brewer, *Social Enterprise*, A-34 – A-65; see Phelan, *Nonprofit Organizations*, Ch. 6.

¹⁶⁵ See Karambelas, *LLC*, §6:26.

¹⁶⁶ See *id.*

¹⁶⁷ See Brewer, *Social Enterprise*, A-39 – A-45.

¹⁶⁸ See Brewer, *Social Enterprise*.

charitable organizations.¹⁶⁹ L3Cs are designed primarily to achieve some charitable purpose, and the “production of income” is an acceptable “secondary purpose” for an L3C.¹⁷⁰ A private foundation’s investment in an L3C may or may not qualify as a program-related investment under federal tax law.¹⁷¹ The state law classification of an L3C as charitable or noncharitable under state law does not affect the IRS’s federal law verdict.¹⁷² The IRS has not spoken on the validity of L3Cs as tax exempt organizations, so the practitioner advising the prospective nonprofit organization should be wary of using an L3C.¹⁷³ 9 states allow L3Cs and some 1,758 L3Cs exist.¹⁷⁴ Kansas and Missouri do not allow domestic L3Cs, but a foreign L3C might be recognized.¹⁷⁵

Conclusion

We have explored incorporating nonprofits in Kansas and Missouri. Attorneys practicing in the tax exempt realm should ensure compliance with Kansas or Missouri law and maintain state and federal tax exempt status throughout the nonprofit’s life cycle.

Members, employees, directors, officers, and even volunteers and donors serving nonprofit corporations would do also well to consult with an attorney and/or accountant to ensure the nonprofit is complying with state and federal law and that the individual’s work with the nonprofit will not have adverse or unforeseen impacts. With careful planning and good counsel, many nonprofits thrive and serve the community well, and individuals can enjoy many years of service in various capacities.

As the Pulitzer Prize winning poet Robert Frost (1874-1963) memorably wrote, may your nonprofit work make a satisfying difference in your life:

Somewhere ages and ages hence
Two roads diverged in a wood, and I –
I took the one less traveled by,
And that has made all the difference.¹⁷⁶

¹⁶⁹ The IRS’ 12 requirements for tax exempt LLCs require all LLC members to be charitable organizations.

¹⁷⁰ See Hopkins, *Tax Exempt*, §4.12(c).

¹⁷¹ See *id.*

¹⁷² See *id.*

¹⁷³ See Karambelas, *LLC*, §6:26.

¹⁷⁴ Vermont, Michigan, Wyoming, Utah, Illinois, North Carolina, Louisiana, Maine, and Rhode Island allow L3Cs. See Brewer, *Social Enterprise*, A-34; “L3C Tally as of 27 November 2019” (<http://www.intersectorl3c.com/l3c>); Carter G. Bishop, “L3C and B Corporation Legislation Table,” (<http://ssrn.com/abstract=1561783>).

¹⁷⁵ V.A.M.S. §355.025; see Van Dyke, *Missouri Corporate Practice*, §18-2.

¹⁷⁶ Robert Frost, “The Road Not Taken,” *Mountain Interval*, 1920.

2. ESTABLISHING AND MAINTAINING TAX EXEMPT STATUS

A client from a nonprofit walks into your office. The nonprofit was properly incorporated under state law. Now the client wants to obtain tax exempt status from the IRS. Attorneys counseling nonprofit clients on establishing tax exempt status with the IRS are well advised to review several resources.¹⁷⁷

A. Nonprofit vs. Tax-Exempt

Nonprofit. The term “nonprofit” applies at the state level where state statutes govern and determine qualification requirements for nonprofit status.¹⁷⁸ These criteria vary from state to state.

Tax exempt. The term “tax exempt” applies at the federal level. Tax exempt organizations are exempt from paying federal income tax.¹⁷⁹

Distinguishing nonprofits and tax exempt organizations is reminiscent of exploring the characteristics of a square vis-à-vis a rectangle in geometry: all tax exempt organizations are nonprofits (as all squares are rectangles), but not all nonprofit organizations are tax exempt (just as all rectangles are not squares). A nonprofit organization under state law must meet federal criteria to obtain tax exempt status from the IRS.¹⁸⁰ Many nonprofits must apply for tax exempt status, but some can be granted tax exempt status automatically.¹⁸¹

The IRS imposes two requirements upon organizations seeking tax exempt status.¹⁸² First, the organization’s activities and business pursuits must be nonprofit in character, satisfying the organizational and operational tests, and not seeking private inurement of benefits to individual members or the organization.¹⁸³ Second, the organization’s purpose

¹⁷⁷ See Hopkins, *The Law of Tax Exempt Organizations and Starting and Managing a Nonprofit Organization*; see Phelan, *Nonprofit Organizations*; see Rosenthal, *Good Counsel*; and the IRS website (www.irs.gov) and publications; see Cassady V. Brewer, Elizabeth C. Minnigh & Robert A. Wexler, *Social Enterprise by Non Profits and Hybrid Organizations* (Bloomberg BNA No. 489). The “organizational” and “operational” tests are well documented. See Webster, *Tax Exempt Organizations*.

¹⁷⁸ K.S.A. §17-6001 *et seq* (West Supp. 2019); V.A.M.S. §355.001 *et seq* (West Supp. 2019); see Garner, *Black’s Law Dictionary*, 417.

¹⁷⁹ See Hopkins, *Tax Exempt Organizations*, §1.2; see Phelan, *Nonprofit Organizations*, §7:40; see Garner, *Black’s Law Dictionary*, 1690.

¹⁸⁰ See Hopkins, *Tax Exempt Organizations*, Ch. 26.

¹⁸¹ Code §§505(c), 508(a); see Webster, *Organization*, A-13.

¹⁸² Failing to pass the organizational and operational tests trigger income taxes. Reg. §1.501(c)(3)-1(a)(1); see Webster, *Organization*, A-9.

¹⁸³ Inurement is a “benefit” to an individual. See Garner, *Black’s Law Dictionary*, 951. See Reg. §1.501(a)-1(a)(1) (organizational and operational tests). Private inurement means “personal benefits” “gravitat[ing] toward or flow[ing] to” “any private shareholder or individual.” Rosenthal, *Good Counsel*, 31. Private inurement describes “transactions whose benefits flow to private individuals, to the detriment of the organization and its charitable purposes.” *Id.*, 32. Federal law prohibits private inurement in a tax exempt organization. Private inurement can come from a business transaction, low/no interest rate loan, or salaries above fair market value. *Id.* The private inurement doctrine comes from an old tax law formulation, requiring tax exempt organizations to be organized and operate so “no part of ... [the organization’s] net

or goal or type must fit within prescribed classifications under the IRS Code.¹⁸⁴ Congress has defined certain activities and business pursuits it deems worthy of being exempt from federal income taxes. If an organization has nonprofit motives and means of achieving those motives which fit within one of the tax exempt categories, the organization stands a good chance of being granted tax exempt status by the IRS.¹⁸⁵

Tax Exempt Advantages

Nonprofits receive several tax advantages upon achieving tax exempt status.¹⁸⁶ First, the nonprofit becomes exempt from federal income tax, except for unrelated business taxable income (UBTI).¹⁸⁷ Second, the nonprofit may be eligible for exemption from state and local taxes in Kansas and Missouri.¹⁸⁸ Third, donors can deduct contributions to tax exempt organizations from the donor's federal income taxes.¹⁸⁹ Fourth, a donor may take federal estate and gift tax deductions.¹⁹⁰ A fifth advantage is the goodwill, prestige by association, or noble endeavor connotations that a nonprofit or tax exempt organization and its employees and volunteers often enjoy in the local community. Sixth, a tax exempt organization may acquire property the U.S. government can declare as "surplus."¹⁹¹ Seventh, 501(c)(3) tax exempt status allows a nonprofit receive funds from United Way and other fundraising drives.¹⁹² Eighth, nonprofits receive a postage discount using Form 3624.¹⁹³ Ninth, some tax exempt organizations may be exempt from some federal excise taxes.¹⁹⁴ Tenth, tax exempt organizations can qualify to issue tax exempt bonds, which are attractive investments since they improve the local community and allow favorable tax treatment for investors.¹⁹⁵

earnings ... inures to the benefit of any private shareholder or individual." Hopkins, *Tax Exempt Organizations*, 548, and Ch. 20.

¹⁸⁴ Code §§ 501(c), 526-529; see also Hopkins, *Tax Exempt Organizations*, 1081-1083. Tax exempt status hinges on 6 criteria: (1) organizational type, (2) organized exclusively for exempt purposes, (3) operated exclusively for exempt purposes, (4) avoiding private inurement, (5) avoiding electioneering, and (6) avoiding substantial lobbying. See Brewer, *Social Enterprise*, A-3. The "organizational" and "operational" tax paradigms are well documented. See e.g. Webster, *Organization and Operation*.

¹⁸⁵ The "profit motives" test is a crucible of nonprofits and trade or business expense deductibility under Code §162. *United States v. American Bar Endowment*, 477 U.S. 105, 111 n.1 (1986) (cited in Webster, *Trade Associations* (Bloomberg BNA No. 614), A-25 – A-35. The profit motives test focuses on (1) trade or business activity that is (2) regularly carried on, but (3) not substantially related to exempt purposes. Reg. §§1.513-1(a); 1.513-1(c)(1) ("regularly carried on"); 1.513-1(d) (substantially related).

¹⁸⁶ See Hopkins, *Tax Exempt Organizations*, §3.4.

¹⁸⁷ Code §511; see Webster, *Organization*, A-3; see Webster, *Operation*, A-95 – A-135.

¹⁸⁸ See Webster, *Organization*, A-3; K.S.A. §§79-32, 113(a), 79-201 et seq; V.A.M.S. §§143.321, 143.441.2, 144.030.2, 137.100(5); Mo. Const., Art. X, §6.

¹⁸⁹ Code §170(c); see Webster, *Organization*, A-3.

¹⁹⁰ Code §§2055 (estate), 2522 (gift); see Webster, *Organization*, A-3.

¹⁹¹ See Webster, *Organization*, A-4.

¹⁹² See Webster, *Organization*, A-4.

¹⁹³ See Webster, *Organization*, A-5.

¹⁹⁴ See Webster, *Organization*, A-5.

¹⁹⁵ Code §§103, 145; see Webster, *Organization*, A-5.

Tax Exempt Disadvantages

While tax exempt status has many advantages, it also carries three disadvantages for some nonprofits.¹⁹⁶ First, the private inurement prohibition keeps “controlling persons” in an organization from receiving “dividends” or any payment that is not “reasonable compensation for goods or services” rendered to the organization.¹⁹⁷ Second, if a nonprofit wants to be a private foundation with tax exempt status, an “onerous” excise tax is triggered.¹⁹⁸ And third, a 501(c)(3) is not only prohibited from partisan political campaigning, but lobbying is “heavily regulated.”¹⁹⁹

Organizational Test

How is the nonprofit organized or legally structured?²⁰⁰ Passing the organizational test hinges on incorporating the nonprofit properly. The organizational test is fairly simple to pass. Let’s briefly explore the organizational test’s landscape.²⁰¹

The IRS will usually presume a nonprofit is a corporation if the nonprofit attaches articles of incorporation to Form 1023 and a certificate of compliance with local nonprofit law.²⁰² An unincorporated association with bylaws passes muster under the organizational test, but unincorporated associations lacking bylaws or other foundational documents do not.²⁰³ A nonprofit trust also passes the organizational test.²⁰⁴ If a nonprofit changes its legal structure during the tax exempt application process, a fresh Form 1023 is required, and the IRS is free to apply *de novo* scrutiny.²⁰⁵ If the nonprofit’s legal structure is something outside the corporation, trust, or unincorporated association parameters, tax exempt status will likely be denied.²⁰⁶

Crafting Articles of Incorporation

To pass the organizational test, the nonprofit’s articles of incorporation must have (1) a purpose clause and (2) a dissolution clause.²⁰⁷ The articles (1) must limit the organization’s purposes to exempt purposes, (2) cannot authorize activities that do not further exempt purposes, (3) and must expressly or impliedly “dedicat[e]” the nonprofit’s assets to an exempt purpose when the nonprofit dissolves.²⁰⁸ If the articles were not well designed and the nonprofit has not begun, the articles may be revised to pass the organizational test.²⁰⁹

¹⁹⁶ See Hopkins, *Tax Exempt Organizations*, §3.5.

¹⁹⁷ See Webster, *Organization*, A-7.

¹⁹⁸ Code §§4940-4958; see Webster, *Organization*, A-7.

¹⁹⁹ Reg. §1.501(c)(3)-1(b)(3); see Webster, *Organization*, A-7, 11; see Webster, *Operation*, A-77 – A-94.

²⁰⁰ See Hopkins, *Tax Exempt Organizations*, §4.3.

²⁰¹ See Webster, *Organization*.

²⁰² See Webster, *Organization*, A-9.

²⁰³ Code §7701(a)(3) (passes); *Trippe v. IRS*, 9 T.C.M. 622 (1950) (fails); see Webster, *Organization*, A-9.

²⁰⁴ *Fifty-Third Union Trust v. IRS*, 56 F.2d 767 (6th Cir. 1932); see Webster, *Organization*, A-9.

²⁰⁵ Rev. Rul. 67-390; see Webster, *Organization*, A-9.

²⁰⁶ See Webster, *Organization*, A-9.

²⁰⁷ See Webster, *Organization*, A-10 – A-11; Reg. §§1.501(c)(3)-1(b)(2), -1(b)(4).

²⁰⁸ Regs. §§1.501(c)(3)-1(b)(1)-(4). An “exempt” purpose must be listed in §501(c)(3). Regs. §§1.501(c)(3)-1(a)(2), (b)(1)(ii), (d)(1)(i). See Webster, *Organization*, A-10.

²⁰⁹ See Webster, *Organization*, A-11; Rev. Proc. 84-47.

Operational Test

Does the nonprofit operate as a nonprofit or tax exempt organization should operate?²¹⁰ Even if the nonprofit's legal and structural design is solid, the nonprofit must pass the operational test to achieve tax exempt status.²¹¹ The operational test is "more important" in the 501(c)(3) exemption calculus.²¹²

An organization is operated exclusively for tax exempt purposes if its activities "primarily" further its exempt purpose(s).²¹³ The IRS "carefully audits" organizations under the operational test.²¹⁴ Comparing tax law restrictions of various exempt organization activities can be helpful to ensure a nonprofit will pass the operational test.²¹⁵

The IRS grants tax exempt status via a determination letter or ruling.²¹⁶ Once tax exempt status is achieved, it must be maintained. Indeed, "one of the organization's most solemn duties is to make sure that it maintains its tax exempt status in good standing."²¹⁷ Later presentations will cover maintaining tax exempt status in detail, but good maintenance hallmarks include (1) making required public disclosures, (2) avoiding private inurement, (3) limited private benefit transactions, and (4) limiting lobbying activity and avoiding prohibited political activity.²¹⁸

B. Determining the Tax Exempt Organization Type Under the IRS Code

IRS Code §§ 501(c), (d), (e), (f), 521, 527, 528, and 529 describe different types of nonprofit organizations eligible for tax exempt status.²¹⁹

i. The 501(c)'s: Classic Nonprofit Paradigms. Most tax exempt organizations fit under 501(c), which is this seminar's primary focus.²²⁰ 501(c) organizations that are eligible for tax exempt status include:

1. *501(c)(1) – Organizations exempt from Federal income tax under any Act of Congress as amended or supplemented before July 18, 1984*

501(c)(1) exempts legacy organizations that were tax exempt before the current IRS Code was enacted.²²¹ 501(c)(1) applies to newer organizations if Congress provides an

²¹⁰ See Hopkins, *Tax Exempt Organizations*, §4.5.

²¹¹ See Webster, *Operation*.

²¹² See Webster, *Organization*, A-12.

²¹³ Reg. §1.501(c)(3)-1(c)(1); see Webster, *Operation*, A-3.

²¹⁴ See Webster, *Operation*, A-3. An activity is "incidental" to the organization's primary purpose depending on: (1) the activity's income vis-à-vis the organization's total income, (2) the activity's expenses vis-à-vis the organization's total expenses, and (3) the activity's time from employees vis-à-vis the total hours worked. *Id.*

²¹⁵ See Webster, *Operation*, B-101.

²¹⁶ See Hopkins, *Tax Exempt Organizations*, §26.1.

²¹⁷ See Rosenthal, *Good Counsel*, 31.

²¹⁸ See *id.*, 31-34; see Hopkins, *Tax Exempt Organizations*, Chs. 22-23.

²¹⁹ See Phelan, *Nonprofit Organizations*, §7:1.

²²⁰ See Hopkins, *Tax Exempt Organizations*, App. C (75 categories of tax exempt organizations).

exemption for the organization.²²² 501(c)(1) exempt organizations include: the Federal Deposit Insurance Corporation, the Federal National Mortgage Association, the Federal Reserve, and some federal credit unions.²²³ 501(c)(1) does not apply to state or municipal government instrumentalities.²²⁴ America has about 100 501(c)(1) organizations.²²⁵

2. *501(c)(2) - Title holding corporations*

501(c)(2) title holding corporations hearken back to an era where state laws often prohibited nonprofits from owning property, so the nonprofit would have a subsidiary title holding corporation to hold title to its real or personal property.²²⁶ A single parent title holding corporation transfers all “its income, less expenses, to a tax-exempt parent” organization.²²⁷ Renting real estate is an acceptable source of income, but renting personal property is conducting an unrelated business.²²⁸ Title holding corporations apply for tax exempt status using Forms 1024 and 8718.²²⁹ In 1986, the IRS Code added multiple parent title holding organizations (IRS Code 501(c)(25)), which are discussed below. 501(c)(2) only applies to corporations and unincorporated associations, not trusts.²³⁰ America has about 5,850 501(c)(2) organizations.²³¹

3. *501(c)(3) - Organizations operating exclusively for religious, charitable, educational, and other specific purposes*

501(c)(3) or charitable organizations are the most well known and most common type of tax exempt organization.²³² The ambit of the 501(c)(3) realm includes: (1) charitable, (2) educational, (3) religious, or (4) scientific organizations.²³³ 508 requires (1) most 501(c)(3) organizations to notify the IRS of its pursuit of tax exempt status and (2) a 501(c)(3) will be presumed to be a private foundation unless it notifies the IRS that it is not a private foundation.²³⁴ 501(c)(3) tax exempt status comes from the organization’s exclusive operational focus on religious, charitable, educational, or similar purposes.²³⁵ The charitable organization umbrella includes religious, charitable, educational, and other

²²¹ See Phelan, *Nonprofit Organizations*, §19.1; see Hopkins, *Tax Exempt Organizations*, §19.1.

²²² Code §501(c)(1)(A); see Webster, *Organization*, A-13 – A-14.

²²³ See Webster, *Organization*, A-14; Rev. Rul. 89-94 (some federal credit unions exempt under §501(c)(1)).

²²⁴ See Webster, *Organization*, A-14, A-71 – A-75.

²²⁵ See Hopkins, *Tax Exempt Organizations*, §2.1.

²²⁶ See Phelan, *Nonprofit Organizations*, §§19.2, 7:31; see Hopkins, *Tax Exempt Organizations*, §19.2.

²²⁷ See Hopkins, *Tax Exempt Organizations*, §19.2(a).

²²⁸ See Phelan, *Nonprofit Organizations*, §19.2(a).

²²⁹ See Phelan, *Nonprofit Organizations*, §7:31.

²³⁰ See Webster, *Organization*, A-14.

²³¹ See Hopkins, *Tax Exempt Organizations*, §2.1.

²³² See Phelan, *Nonprofit Organizations*, §7:5 and Chs. 8-10; see Webster, *Organization*, A-17, A-77 – A-78; see Webster, *Operation*, A-17 – A-46; see Hopkins, *Tax Exempt Organizations*, Chs. 6-12.

²³³ See Hopkins, *Nonprofit*, 33-38.

²³⁴ Code §§508(a), (b); see Webster, *Organization*, A-101.

²³⁵ See Hopkins, *Tax Exempt Organizations*, Ch 6; see Hopkins, *Nonprofit*, 33-35 (charitable), 35-36 (educational), 36-38 (religious), 38 (scientific).

purposes.²³⁶ Donors to charitable organizations receive a federal income tax charitable contribution deduction.²³⁷ Charitable organizations can focus on relief of poor or distressed people, credit counseling, housing provision, down payment assistance, promotion of health, lessening governmental burdens, advancing education, science, or religion, promoting social welfare or the arts, or other initiatives.²³⁸ Religious organizations – including churches, synagogues, and mosques – have some unique tax issues and are often granted favorable state law treatment with minimal filing requirements.²³⁹ Charitable trusts and split interest trusts can also be charitable organizations.²⁴⁰

A 501(c)(3) or 501(c)(4) organization cannot have private inurement or private benefit occurring towards an organization member, shareholder, or individual.²⁴¹ America has nearly 1 million 501(c)(3) organizations.²⁴²

4. *501(c)(4) - Civic leagues, social welfare organizations, local associations of employees limited in membership with the net earnings used exclusively for charitable, educational, or recreational purposes*

501(c)(4) social welfare organizations overlap with 501(c)(3) charitable organizations but are distinctly focused on social welfare and require a community benefit or improvement.²⁴³ Social welfare encompasses promoting the “common good and general welfare,” “civic betterments and social improvements,” but excludes conducting business for a profit with the general public or political campaign activities.²⁴⁴ A geographically local association of employees can also apply under 501(c)(4).²⁴⁵ 501(c)(4) organizations

²³⁶ See Hopkins, *Tax Exempt Organizations*, Chs. 10 (religious), 7 (charitable), 8 (educational), 9 (scientific), and 11 (others); see Webster, *Operation*, A-47 – A-52 (educational); *id.*, A-53 – A-56 (scientific); *id.*, A-57 – A-60.

²³⁷ See Phelan, *Nonprofit Organizations*, §6.1(c), 152 (citing Code §170(c)(2)(B)). Donations to other tax exempt organizations – e.g. civic or business leagues, chambers of commerce, and social or recreational clubs – are *not* often deductible for donors. See Rosenthal, *Good Counsel*, 28; see Phelan, *Nonprofit Organizations*, §§7:1, 7:14.

²³⁸ See Hopkins, *Tax Exempt Organizations*, Ch. 7; Hopkins, *Nonprofit*, 38-39; Reg. §1.501(c)(2)-1(a) (a title holding corporation cannot do other activities and be exempt under §501(c)(2)); see Webster, *Organization*, A-14.

²³⁹ See Nina J. Crimm, *Tax Issues of Religious Organizations* (Bloomberg BNA No. 484-2nd, 2015); see Webster, *Operation*, A-9 – A-16.

²⁴⁰ See Phelan, *Nonprofit Organizations*, §§7:9 (charitable trusts) and 7:10 (split interest trusts).

²⁴¹ See Webster, *Operation*, A-61 – A-76.

²⁴² See Hopkins, *Tax Exempt Organizations*, §2.1.

²⁴³ See Phelan, *Nonprofit Organizations*, §7:15; see Hopkins, *Tax Exempt Organizations*, Ch. 13; Hopkins, *Nonprofit*, 39; see Webster, *Organization*, A-17 – A-20.

²⁴⁴ Regs. §§1.501(c)(4)-1(a)(2)(i), (ii); see Webster, *Organization*, A-17, A-20. See Hopkins, *Tax Exempt Organizations*, §13.1(a). 501(c)(3) and (4) organizations should avoid the penalty tax for “excess benefit transactions.” See Phelan, *Nonprofit Organizations*, §7:16.

²⁴⁵ See Webster, *Organization*, A-20.

apply for tax exempt status on Form 1024.²⁴⁶ America has about 116,890 501(c)(4) organizations.²⁴⁷

5. *501(c)(5) - Labor, agricultural, or horticultural organizations*

501(c)(5) encompasses labor, agricultural, or horticultural organizations.²⁴⁸ 501(c)(5)s cannot provide net earnings to members and the organization must “have as its principal object the betterment of the conditions of those engaged in the exempt pursuits, the improvement of the grade of their products, and the development of a higher degree of efficiency in the particular occupation.”²⁴⁹ A “labor organization” is broadly interpreted as “an association of workers who have combined to protect or promote their interests by bargaining collectively with their employers to secure better working conditions, wages, and similar benefits.”²⁵⁰ An agricultural organization must prove its agricultural mission for tax purposes, although the term “agriculture” is liberally construed.²⁵¹ Horticultural organizations, such as garden clubs, focus on improving the art and science of cultivating fruits, flowers, and vegetables.²⁵² America has about 56,819 501(c)(5) organizations.²⁵³

6. *501(c)(6) - Business leagues, chambers of commerce, real estate boards, boards of trade, or professional football leagues*

501(c)(6) organizations have a common business pursuit that often spills over into for profit activities, such as chambers of commerce, boards of trade, real estate boards, and professional football leagues.²⁵⁴ Tax exempt business leagues have 6 defining characteristics: “an association of (1) persons having a common business interest; (2) ... to promote that common business interest; (3) ... not organized for profit; (4) that does not engage ... in a business ordinarily conducted for profit; (5) [with] activities ... directed to the improvement of business conditions in one or more lines of business ... and (6) [similar to] a chamber of commerce, board of trade, or the like.”²⁵⁵ The IRS

²⁴⁶ Rev. Proc. 2013-8; see Webster, *Organization*, A-17, A-20.

²⁴⁷ See Hopkins, *Tax Exempt Organizations*, §2.1.

²⁴⁸ See Webster, *Organization*, A-20; see Phelan, *Nonprofit Organizations*, §7:11; see Hopkins, *Tax Exempt Organizations*, Ch. 13 (social welfare organizations), Ch. 16; see Hopkins, *Nonprofit*, 41 (labor organizations).

²⁴⁹ Reg. §1.501(c)(5)-1(a); see Webster, *Organization*, A-20; see Hopkins, *Tax Exempt Organizations*, 445.

²⁵⁰ See Webster, *Organization*, A-20.

²⁵¹ Code §501(g); see Webster, *Organization*, A-20; see Hopkins, *Tax Exempt Organizations*, §16.2; Hopkins, *Nonprofit*, 41.

²⁵² See Webster, *Organization*, A-22 – A-23; see Hopkins, *Tax Exempt Organizations*, §16.3; Hopkins, *Nonprofit*, 41.

²⁵³ See Hopkins, *Tax Exempt Organizations*, §2.1.

²⁵⁴ Rev. Rul. 67-176; see Webster, *Organization*, A-24 – A-27; see Phelan, *Nonprofit Organizations*, §7:18; see Hopkins, *Tax Exempt Organizations*, Ch. 14, §14.1; Hopkins, *Nonprofit*, 40; see Webster, *Trade Associations*.

²⁵⁵ Reg. §1.501(c)(6)-1; see Hopkins, *Tax Exempt Organizations*, §14.1(a)(i); see Webster, *Trade Associations*, B-101 – B-114 (reprinting IRM 7.25.6); Webster, *Trade Associations* (citing Reg. 1.501(c)(6)-1; PLR 201347022; *Bluetooth SIG, Inc. v. United States*, 611 F.3d 617 (9th Cir. 2010)); Webster, *Trade Associations*, 1 n.3 (quoting IRS Pub. 557 (“Trade associations and professional associations are considered business leagues”)).

hones in on a distinction – the line of business test - between activities directed towards “improvement of business conditions” vis-à-vis “performance of particular services for individual persons.”²⁵⁶ An organization that improves business conditions may be tax exempt, while an organization that performs particular services for individuals cannot be tax exempt under 501(c)(6).

Tax exempt professional organizations – for attorneys, accountants, engineers, physicians, or other professions – fit within the 501(c)(6) category.²⁵⁷ Business leagues may fail to qualify for tax exempt status for 4 reasons: (1) if they do not represent an entire line of business, including various “competitors within a trade, industry, or profession,” (2) if they engage in for-profit business activities except incidentally, (3) if they perform particular services, conveniences, or economies for individuals or members, or (4) private inurement, e.g. “income or assets of an exempt business league ... [cannot] directly or indirectly benefit an individual or other person who has a close relationship with the organization, when they are in a position to exercise a significant degree of control over it.”²⁵⁸ In contrast to a business league, which “promote[s] the common business interests of persons within a line of business,” a chamber of commerce “promote[s] the common business interests of persons within a community” or “defined geographic area.”²⁵⁹ Tightening the focus on the chamber of commerce designation, a board of trade promotes “one or more lines of business in a particular geographic area.”²⁶⁰ Real estate boards were included as tax exempt organizations in response to a 1929 7th Circuit Court decision.²⁶¹ Professional football leagues were added as a tax exempt organization category to prevent pension plans from being construed as “a means of conferring private inurement to individuals.”²⁶² Dues for a 501(c)(6) organization are fully deductible as business expenses.²⁶³ A 501(c)(6) must file a tax exempt application and receive a formal IRS determination letter to achieve tax exempt status.²⁶⁴ America has about 71,878 501(c)(6) organizations.²⁶⁵

²⁵⁶ See Hopkins, *Tax Exempt Organizations*, §14.2(a); Webster, *Trade Associations*, A-11 – A-15 (citing *National Muffler Dealers Ass’n v. United States*, 440 U.S. 472 (1979) (upholding line of business requirement)).

²⁵⁷ See Hopkins, *Tax Exempt Organizations*, §14.1(e); Webster, *Trade Associations*, A-23 – A-24 (citing Rev. Rul. 71-504, 71-505, and 71-506).

²⁵⁸ See Hopkins, *Tax Exempt Organizations*, §14.2(a) and Webster, *Trade Associations*, A-11 – A-15 (Reason 1); see *id.*, §14.2(b) and *id.*, A-18 – A-19 (Reason 2); see *id.*, §14.2(c) and *id.*, A-15 – A-18 and Reg. 1.501(c)(6)-1 (Reason 3); see *id.*, §14.2(d) and *id.*, A-19 – A-22 (Reason 4).

²⁵⁹ See Hopkins, *Tax Exempt Organizations*, §14.3.

²⁶⁰ See *id.*, §14.4.

²⁶¹ See *id.*, §14.5.

²⁶² See *id.*, §19.20. The Chief’s Lamar Hunt lobbied for tax exempt status for professional football.

²⁶³ Code §162; Reg. §1.162-15(c); see Webster, *Trade Associations*, A-2 – A-3.

²⁶⁴ Reg. §1.501(a)-1(a)(2); see Webster, *Trade Associations*, A-51.

²⁶⁵ See Hopkins, *Tax Exempt Organizations*, §2.1.

7. 501(c)(7) - Social and recreation clubs

501(c)(7) organizations include social, recreational, and country clubs.²⁶⁶ Clubs have been tax exempt since 1916.²⁶⁷ A “club” “must be an established membership” and “a commingling of members must play a material part” in the activities.”²⁶⁸ Social clubs receive tax exempt status because “no part of the net earnings” “inures to the benefit of any private shareholder [or member],” although the organization exists for members’ “pleasure, recreation, and other nonprofitable purposes.”²⁶⁹ A social club’s income other than “exempt function” income is subject to UBTI.²⁷⁰ In crafting the IRS Code, Congress focused on income shifting from one person or business to another.²⁷¹ Since social clubs do not shift income from one member to another member, they can be tax exempt organizations.²⁷² Tax exempt social clubs “must meet an organizational test and an operational test,” including “commingling” of members “play[ing] a material part” in the organization’s life.²⁷³ Country clubs, dinner clubs, swim, golf, and tennis clubs are the archetype social clubs, but the concept may be stretched more broadly within the IRS’ good graces.²⁷⁴ America has about 56,369 501(c)(7) organizations.²⁷⁵

8. 501(c)(8) - Fraternal beneficiary societies, orders, or associations

501(c)(8) organizations operate under the lodge system and provide payment of life, sick, accident, and other benefits to members or their dependents, or fraternal beneficiary societies that channel net earnings to religious, charitable, scientific, literary, educational, and fraternal purposes.²⁷⁶ 501(c)(8) organizations often conduct “extensive charitable activities” among the public and organization members, which bolster continuing their tax exempt status.²⁷⁷ Fraternal beneficiary societies file a Form 1024 for tax exempt

²⁶⁶ Reg. §1.501(c)(7)-1(a); see Webster, *Organization*, A-27 – A-30. See Hopkins, *Tax Exempt Organizations*, Ch. 15; see Phelan, *Nonprofit Organizations*, §7:19; see Hopkins, *Nonprofit*, 41.

²⁶⁷ See Webster, *Organization*, A-27.

²⁶⁸ Rev. Rul. 70-32; see Webster, *Organization*, A-27.

²⁶⁹ See Hopkins, *Tax Exempt Organizations*, §15.1. The nonprofit’s provision of pleasure or recreation to members is “paramount” to tax exempt status. *Id.*, §15.1(b). Ironically for more democratic readers, opening a social club’s facilities to the “general public” for pleasure or recreation forfeits tax exempt status since the general public using the social club “may be considered as engaging in business,” which is prohibited. *Id.*, §15.2.

²⁷⁰ Code §512(a)(3); see Webster, *Organization*, A-27; see Webster, *Operation*, A-131 – A-134.

²⁷¹ Some non-deductible §501(c)(7) dues, including country club initiation fees and dues, contrasts with the full business expense deductibility of §501(c)(6) dues. Before the 1986 Tax Reform Act, country club dues were deductible business expenses, but the old rule changed to limit perceived tax abuses, and the old law imposed higher tax rates while granting country club deductions. Code 274(a)(3); see Hopkins, *Tax Exempt Organizations*, §15.1(c). Business meals are 50% deductible under the meals and entertainment rules. §501(c)(7) dues are deductible expenses for corporations, but not individuals, under the reasonable wage and compensation rules. See Mitchell Stump, *Club Tax Book* (2015).

²⁷² See Hopkins, *Tax Exempt Organizations*, §15.1(a).

²⁷³ See Hopkins, *Tax Exempt Organizations*, §15.1(b).

²⁷⁴ See Hopkins, *Tax Exempt Organizations*, §15.1(b).

²⁷⁵ See Hopkins, *Tax Exempt Organizations*, §2.1.

²⁷⁶ See *id.*, §19.4; see *id.*, §19.4(a); see *id.*, §§19.4(a), (b); see Phelan, *Nonprofit Organizations*, §7:20; see Hopkins, *Nonprofit*, 42; see Webster, *Organization*, A-30 – A-31.

²⁷⁷ See Webster, *Organization*, A-31.

status and were defined by an early court case.²⁷⁸ America has about 63,818 501(c)(8) organizations.²⁷⁹

9. *501(c)(9) - Voluntary employees' beneficiary associations providing benefits to members or their dependents*

501(c)(9) organizations (VEBAs) provide payment of life, sick, accident, and other benefits to association members or their dependents.²⁸⁰ Severance benefits are permitted.²⁸¹ Supplemental unemployment benefits are also allowed.²⁸² A 501(c)(9) must have voluntary membership.²⁸³ A VEBA must meet particular criteria.²⁸⁴ No VEBA net earnings may inure to a shareholder or individual's benefit.²⁸⁵ Most VEBAs must follow the 27 month rule: notifying the IRS of their tax exempt application within 27 months of incorporation or formation under state law.²⁸⁶ America has about 10,088 501(c)(9) organizations.²⁸⁷

10. *501(c)(10) - Domestic fraternal societies, orders, or associations operating under the lodge system with net earnings devoted exclusively to religious, charitable, scientific, literary, educational, or fraternal purposes*

501(c)(10) organizations operate under the lodge system and channel net earnings to religious, charitable, scientific, literary, educational, and fraternal purposes.²⁸⁸ 501(c)(10) organizations combine some elements of 501(c)(3) and 501(c)(8) organizations.²⁸⁹ 501(c)(10) domestic fraternal societies file a Form 1024 for tax exempt status.²⁹⁰ America has about 20,944 501(c)(10) organizations.²⁹¹

11. *501(c)(11) - Local teachers' retirement fund associations*

501(c)(11) organizations are another employee benefit fund type, specifically focused on (1) local geography and (2) occupation – e.g. local teachers' retirement funding.²⁹²

²⁷⁸ *Nat'l Union v. Marlow*, 74 F.775, 778 (8th Cir. 1896); see Webster, *Organization*, A-30; see Phelan, *Nonprofit Organizations*, §7:20.

²⁷⁹ See Hopkins, *Tax Exempt Organizations*, §2.1.

²⁸⁰ Regs. §§1.501(c)(9)-1, -3; see Webster, *Organization*, A-34; see Webster, *Organization*, A-31; see Hopkins, *Tax Exempt Organizations*, §18.3; see Phelan, *Nonprofit Organizations*, §7:21.

²⁸¹ Reg. §1.501(c)(9)-3(e); see Webster, *Organization*, A-34.

²⁸² Reg. §1.501(c)(17)-3(b); see Webster, *Organization*, A-36.

²⁸³ See Webster, *Organization*, A-31.

²⁸⁴ See Webster, *Organization*, A-33.

²⁸⁵ Reg. §1.501(c)(9)-4(b); see Webster, *Organization*, A-32.

²⁸⁶ See Webster, *Organization*, A-32; see Hopkins, *Tax Exempt Organizations*, §25.3.

²⁸⁷ See Hopkins, *Tax Exempt Organizations*, §2.1.

²⁸⁸ See Hopkins, *Tax Exempt Organizations*, §19.4(b); see Phelan, *Nonprofit Organizations*, §7:20.

²⁸⁹ §501(c)(10) organizations are distinct. Reg. §1.501(c)(10)-1(a); Rev. Rul. 76-457 (§501(c)(8) status required providing insurance, but §501(c)(10) status did not require insurance); see Webster, *Organization*, A-36.

²⁹⁰ See Phelan, *Nonprofit Organizations*, §7:20.

²⁹¹ See Hopkins, *Tax Exempt Organizations*, §2.1.

²⁹² See Hopkins, *Tax Exempt Organizations*, §18.7; see Phelan, *Nonprofit Organizations*, §7:31.

501(c)(11) organizations combine some elements of 501(c)(6) and 501(c)(9) organizations. The IRS does not provide a specific technique to achieve 501(c)(11) tax exempt status.²⁹³ America has 11 501(c)(11) organizations.²⁹⁴

12. *501(c)(12) - Local benevolent life insurance associations, mutual ditch or irrigation companies, mutual or cooperative telephone companies, or similar organizations*

501(c)(12) organizations are a type of benefit or mutual organization, usually focused on local geography and often requiring 85% or more of the organization's income from members for meeting losses and expenses.²⁹⁵ 501(c)(12) organizations use Forms 1024 and 8718 to apply for tax exempt status.²⁹⁶ America has about 5,901 501(c)(12) organizations.²⁹⁷

13. *501(c)(13) - Cemetery companies operated exclusively for their members or not operated for profit*

501(c)(13) organizations (1) own a cemetery, (2) sell plots for burial, and (3) maintain plots for burial and cremation uses, but that do not conduct business outside of those parameters.²⁹⁸ A pet cemetery cannot be a 501(c)(13) organization.²⁹⁹ America has about 9,808 501(c)(13) organizations.³⁰⁰

14. *501(c)(14) - Credit unions, corporations, or associations operated for mutual purposes and without profit*

501(c)(14) organizations operate as nonprofits for members' benefit.³⁰¹ A credit union must be "democratically controlled, cooperative, nonprofit society organized for the purpose of encouraging thrift and self-reliance among its members by creating a source of credit at a fair and reasonable rate of interest ... to improve the economic and social conditions of its members."³⁰² Credit unions achieve tax exempt status through the IRS' Cincinnati Service Center.³⁰³ America has about 3,565 501(c)(14) organizations.³⁰⁴

15. *501(c)(15) - Small non-life insurance companies*

²⁹³ See Webster, *Organization*, A-37.

²⁹⁴ See Hopkins, *Tax Exempt Organizations*, §2.1.

²⁹⁵ See Webster, *Organization*, A-37 – A-39; see Hopkins, *Tax Exempt Organizations*, §19.5; see Phelan, *Nonprofit Organizations*, §7:22.

²⁹⁶ See Phelan, *Nonprofit Organizations*, §7:22.

²⁹⁷ See Hopkins, *Tax Exempt Organizations*, §2.1.

²⁹⁸ See Webster, *Organization*, A-39 – A-41; see Hopkins, *Tax Exempt Organizations*, §19.6; see Phelan, *Nonprofit Organizations*, §7:23.

²⁹⁹ Rev. Rul. 73-454; see Webster, *Organization*, A-40.

³⁰⁰ See Hopkins, *Tax Exempt Organizations*, §2.1.

³⁰¹ See Hopkins, *Tax Exempt Organizations*, §19.7; see Webster, *Organization*, A-40 – A-41; see Phelan, *Nonprofit Organizations*, §7:31.

³⁰² See Hopkins, *Tax Exempt Organizations*, §19.7.

³⁰³ See Webster, *Organization*, A-40; see Phelan, *Nonprofit Organizations*, §7:32.

³⁰⁴ See Hopkins, *Tax Exempt Organizations*, §2.1.

501(c)(15) organizations include interinsurers and reciprocal underwriters that handle less than \$150,000 annually in receipts and premiums for insurance policies.³⁰⁵ America has about 1,646 501(c)(15) organizations.³⁰⁶

16. *501(c)(16) - Crop financing organizations*

501(c)(16) organizations are farmers' co-ops and may finance members' crop operations.³⁰⁷ Crop financing organizations and farmer's cooperative organizations are closely related.³⁰⁸ There is no exemption application form for a 501(c)(16).³⁰⁹ The capital stock reserve or surplus regulations also apply.³¹⁰ America has 16 501(c)(16) organizations.³¹¹

17. *501(c)(17) - Supplemental unemployment benefit trusts*

501(c)(17) organizations pay supplemental unemployment compensation benefits (SUB) to laid off or ill employees that supplement state unemployment benefits.³¹² A SUB is a type of welfare benefit fund, cannot discriminate in favor of supervisory or highly paid employees, and all SUB corpus and income must be used exclusively for supplementary unemployment benefits.³¹³ A SUB files for tax exempt status using Forms 1024 and 8718.³¹⁴ America has 300 501(c)(17) organizations.³¹⁵

18. *501(c)(18) - Pre-1959 employee-funded pension trusts*

501(c)(18) organizations are legacy employee-funded pension trusts, started before 1959.³¹⁶ A 501(c)(18)'s tax exempt status can be revoked if a prohibited transaction with a related party occurs.³¹⁷

19. *501(c)(19) - A post, organization, or auxiliary unit, comprised of present and past members of the Armed Forces and their family members*

501(c)(19) organizations provide benefits to war veterans and their spouses and family members.³¹⁸ Before 501(c)(19) was introduced, war veterans' organizations were granted

³⁰⁵ See Phelan, *Nonprofit Organizations*, §7:31; see Hopkins, *Tax Exempt Organizations*, §19.9; see Webster, *Organization*, A-41 – A-42.

³⁰⁶ See Hopkins, *Tax Exempt Organizations*, §2.1.

³⁰⁷ See Phelan, *Nonprofit Organizations*, §§7:25, 7:31; see Hopkins, *Tax Exempt Organizations*, §19.10.

³⁰⁸ See Phelan, *Nonprofit Organizations*, §§7:25, 7:31.

³⁰⁹ See Webster, *Organization*, A-42.

³¹⁰ Reg. 1.521-1; see Webster, *Organization*, A-42.

³¹¹ See Hopkins, *Tax Exempt Organizations*, §2.1.

³¹² See Webster, *Organization*, A-42 – A-44; see Hopkins, *Tax Exempt Organizations*, §18.4; see Phelan, *Nonprofit Organizations*, §7:31.

³¹³ See Hopkins, *Tax Exempt Organizations*, §18.4.

³¹⁴ See Phelan, *Nonprofit Organizations*, §7:31.

³¹⁵ See Hopkins, *Tax Exempt Organizations*, §2.1.

³¹⁶ See Hopkins, *Tax Exempt Organizations*, §18.6.

³¹⁷ See Webster, *Organization*, A-44.

³¹⁸ See Hopkins, *Tax Exempt Organizations*, §19.11, 476-478; see Phelan, *Nonprofit Organizations*, §7:24.

tax exempt status under 501(c)(4).³¹⁹ A 501(c)(19) must have at least 90% war veteran membership.³²⁰ War veterans' organizations file Form 1024 to apply for tax exempt status and contributions are tax deductible.³²¹ America has about 35,113 501(c)(19) organizations.³²²

20. *501(c)(20) - Organizations or trusts established to provide qualified group legal services plans*

501(c)(20) applies to legacy organizations, formed before 1992.³²³ Since 1992, 501(c)(20) organizations are under the 501(c)(9) umbrella.³²⁴

21. *501(c)(21) - Black lung benefit trusts*

501(c)(21) trusts are recognized in connection with the Federal Coal Mine Health and Safety Act (1969) and state laws.³²⁵ An eligible trust must be irrevocable, domestic, and created to satisfy a coal mine operator's liability for black lung issues.³²⁶ Black lung trusts apply for tax exempt status via letter with a copy of the trust instrument, file a Form 990-BL return annually, and contributions are tax deductible.³²⁷ A 501(c)(21) trust can also pay accident or health benefits for retired miners, spouses, and dependents.³²⁸ Excise taxes do apply to 501(c)(21) trusts.³²⁹ America has 28 501(c)(21) organizations.³³⁰

22. **501(c)(22) – Some ERISA trusts**

501(c)(22) trusts include some, but not all, trusts under ERISA.³³¹ ERISA and employee benefits law are complex, so experienced professionals should be consulted.

23. *501(c)(23) – Armed Forces Organizations - Pre-1880 veterans organizations providing benefits to veterans or their dependents*

501(c)(23) organizations are a specific type of veterans' organization, established before 1880, where over 75% of the members are present or past U.S. Armed Forces members,

³¹⁹ See Webster, *Organization*, A-19; Rev. Rul. 68-45.

³²⁰ Rev. Rul. 84-140; see Webster, *Organization*, A-44 – A-45.

³²¹ See Phelan, *Nonprofit Organizations*, §7:24.

³²² See Hopkins, *Tax Exempt Organizations*, §2.1.

³²³ See Webster, *Organization*, A-46.

³²⁴ See IRS Pub. 557, Ch. 4.

³²⁵ See Hopkins, *Tax Exempt Organizations*, §18.5, 487, n.106.

³²⁶ See Webster, *Organization*, A-46.

³²⁷ See Phelan, *Nonprofit Organizations*, §7:31.

³²⁸ See Webster, *Organization*, A-46.

³²⁹ Code §§4951 – 4953; see Webster, *Organization*, A-46.

³³⁰ See Hopkins, *Tax Exempt Organizations*, §2.1.

³³¹ See Hopkins, *Tax Exempt Organizations*, §18.7; see Webster, *Organization*, A-46; see 29 U.S.C. §1001 et seq.

to provide insurance and other benefits to veterans or their dependents.³³² 501(c)(23) are more flexible than 501(c)(19) organizations.³³³

24. *501(c)(24) - Some single-employer benefit trusts under ERISA §4049*

501(c)(24) trusts are a carve out exception to the ERISA trusts under 501(c)(22), in this case, created by ERISA §4049.³³⁴ Again, because of ERISA and employee benefit law nuances, experienced professionals must be consulted.

25. *501(c)(25) - Title holding corporations or trusts for multiple exempt parent organizations*

501(c)(25) organizations have *multiple* tax exempt parent organizations, vis-à-vis *one* tax exempt parent organization for 501(c)(2) organizations, but must own property directly and not as tenants in common or a similar form of concurrent or joint tenancy.³³⁵ A 501(c)(25) must (1) be a corporation or trust, (2) have up to 35 shareholders or beneficiaries, (3) one stock class or beneficiary group, (4) organized only to hold real estate, and (5) shareholders or beneficiaries must have certain rights.³³⁶ 501(c)(25) organizations use a Form 1024 to apply for tax exempt status.³³⁷ America has about 1,133 501(c)(25) organizations.³³⁸

26. *501(c)(26) - State-sponsored high-risk health coverage organizations*

501(c)(26) organizations are state sponsored health insurance providers to high risk individuals.³³⁹ A 501(c)(26) organization must (1) have a state-specific membership and (2) prohibit private inurement on net earnings to private individuals.³⁴⁰ How the Affordable Care Act's (2010) individual mandate, state health insurance exchanges, and mandate to insure high risk individuals with pre-existing conditions on financial par with low risk or healthy individuals will affect 501(c)(26) organizations remains to be seen. America has 10 501(c)(26) organizations.³⁴¹

³³² See Hopkins, *Tax Exempt Organizations*, §§1.2, 19.11(b); see Webster, *Organization*, A-46.

³³³ "Substantially all" of §501(c)(19) members have to be cadets, spouses, widows, widowers, or lineal descendants of past or present U.S. Armed Forces members. Since 501(c)(23) lacks this requirement, 501(c)(23) exempt status is simpler to achieve. See Webster, *Organization*, A-46.

³³⁴ See Webster, *Organization*, A-46; see Hopkins, *Tax Exempt Organizations*, §18.7.

³³⁵ See Hopkins, *Tax Exempt Organizations*, §19.2(b); see Phelan, *Nonprofit Organizations*, §7:31; see Webster, *Organization*, A-15 – A-17.

³³⁶ See Webster, *Organization*, A-15.

³³⁷ See Phelan, *Nonprofit Organizations*, §7:31.

³³⁸ See Hopkins, *Tax Exempt Organizations*, §2.1.

³³⁹ See Hopkins, *Tax Exempt Organizations*, §19.15.

³⁴⁰ Code §506(c)(26)(C), (D); see Webster, *Organization*, A-46.

³⁴¹ See Hopkins, *Tax Exempt Organizations*, §2.1.

27. *501(c)(27) - State-sponsored workers' compensation organizations*

501(c)(27) affects legacy organizations (pre June 1, 1996) that provide state-sponsored workers' compensation reinsurance for claims within the state.³⁴² America has 12 501(c)(27) organizations.³⁴³

28. *501(c)(28) - National railroad retirement investment trusts*

501(c)(28) investment trusts were enacted as part of the Railroad Retirement Act (1974) to provide retirement benefits to railroad workers.³⁴⁴

29. *501(c)(29) – Qualified Nonprofit Health Insurance Issuers (NHIIs)*

The Affordable Care Act §1322(h)(1) added NHIIs to the IRS Code addition, providing tax exempt status to entities receiving a grant or loan under the Centers for Medicare and Medicaid Services co-op program.³⁴⁵ NHIIs are nonprofit, member corporations whose substantial activity is issuing qualified health plans in each state's individual and small group and an NHI: (a) was not a health insurance issuer as of July 16, 2009, (b) is not sponsored by a state or local government, (c) uses any profits to lower member premiums, improve benefits, or health care quality, (d) meets all state law requirements for issuing qualified health plans, and (e) does not offer a health plan in a state without market reforms required by the Public Health Service Act (1944) and the Affordable Care Act.³⁴⁶

b. *501(c)(3): Public Charity or Private Foundation?*

Many tax issues hinge on whether a 501(c)(3) charitable organization is a public charity or a private foundation.³⁴⁷ A private foundation under 501(c)(3) should be distinguished from a public charity under 509(a).³⁴⁸ The private foundation rules are applied separately from the 501(c)(3) criteria, so the organization must choose whether to be a public charity or private foundations and pursue the correct designation.³⁴⁹ Federal law defines private foundations by an exclusionary process, listing “types of charitable organizations

³⁴² See Webster, *Organization*, A-46 – A-47; see Hopkins, *Tax Exempt Organizations*, §§1.2, 19.16.

³⁴³ See Hopkins, *Tax Exempt Organizations*, §2.1.

³⁴⁴ See Hopkins, *Tax Exempt Organizations*, §19.17

³⁴⁵ See Phelan, *Nonprofit Organizations*, §7:31; see IRS Notice 2011-23 (NHI tax exemption requirements) and the IRS website ([http://www.irs.gov/Charities-&-Non-Profits/New-Guidance-for-IRC-501\(c\)\(29\)-Qualified-Nonprofit-Health-Insurance-Issuers](http://www.irs.gov/Charities-&-Non-Profits/New-Guidance-for-IRC-501(c)(29)-Qualified-Nonprofit-Health-Insurance-Issuers)); see Hopkins, *Tax Exempt Organizations*, §19.18; see Webster, *Organization*, A-13; see John R. Washlick, *Nonprofit Healthcare Organizations* (BNA No. 486, 2015). The Affordable Care Act has survived two challenges. See *NFIB v. Sebelius*, 567 U.S. 519 (2012), and *King v. Burwell*, 576 U.S. 988 (2015).

³⁴⁶ See Phelan, *Nonprofit Organizations*, §7:31.

³⁴⁷ See Hopkins, *Tax-Exempt Organizations*, Ch. 12; see Phelan, *Nonprofit Organizations*, Chs. 9 and 10, §7:6; see Lauren W. Cesare, *Private Foundations and Public Charities* (BNA No. 456), B-201 (checklist); see Webster, *Organization*, A-79 – A-100.

³⁴⁸ See Hopkins & Blazek, *Private Foundations: Tax Law and Compliance* (Wiley, 5th ed., 2018); see Cesare, *Private Foundations*, A-7, A-9 – A-17.

³⁴⁹ See Webster, *Organization*, A-108.

that are not private foundations.”³⁵⁰ Public charities include “churches, educational institutions, hospitals, medical research organizations, publicly supported organizations assisting governmental educational institutions, governmental units, other publicly supported charitable organizations, certain supporting organizations, and entities engaged in testing for public safety.”³⁵¹ Charitable organizations are presumed to be private foundations unless the organization can be demonstrated to be a public charity.³⁵²

A public charity is “[1] an institution (such as a university or hospital), [2] an organization that has broad public support,” or [3] an organization that has a “supporting relationship” with “one or more institutions or publicly supported entities.”³⁵³ A public charity receives more than one-third of its support from the public, and up to one-third of its support from gross investment income.³⁵⁴ Since a public charity receives most of its funding from the public, a public charity can be differentiated from a private foundation by a glance at the funding sources. A public charity can also support another public charity. Four types of public charities exist: (1) institutions, (2) publicly supported charities, (3) supporting organizations, and (4) public safety organizations.³⁵⁵

In contrast to a public charity, a private foundation has four defining characteristics: (1) it is a charitable organization, (2) it has one private funding source, (3) its ongoing funding comes from investment income (not contributions and/or grants), and (4) it makes charitable grants to others (it does not have its own programs).³⁵⁶ A private operating foundation must meet 4 additional tests to qualify for tax-exempt status: (1) an income test, (2) an assets test, (3) an endowment test, and (4) a support test.³⁵⁷ The income test requires the private operating foundation spend substantially all of the lesser of its (a) adjusted net income or its (b) minimum investment return directly for its exempt charitable activities.³⁵⁸ The assets test is satisfied if “substantially more than one half” of assets are (a) spent directly for its charitable activities, to functionally related business, or a combination, (b) corporate stock controlled by the foundation and substantially all the assets spent on its charitable activities, or (c) a mixture of assets in the first two categories.³⁵⁹ The private operating foundation’s endowment test is satisfied by spending at least two-thirds of its minimum investment return on its charitable activities.³⁶⁰ And the private operating foundation’s support test is satisfied if (1) substantially all its

³⁵⁰ See Hopkins, *Tax Exempt Organizations*, §12.1(a) (citing Code §509(a)); see Phelan, *Nonprofit Organizations*, §7:7; see Cesare, *Private Foundations*, A-1.

³⁵¹ See Phelan, *Nonprofit Organizations*, §7:6 and Ch. 9; see Cesare, *Private Foundations*, A-1.

³⁵² Code §508; Reg. §1.508-1(b); see Hopkins, *Tax Exempt Organizations*, §12.1(a).

³⁵³ See Hopkins, *Tax Exempt Organizations*, §12.3.

³⁵⁴ See Hopkins, *Tax Exempt Organizations*, §12.3(b)(1).

³⁵⁵ See Hopkins, *Tax Exempt Organizations*, §12.3.

³⁵⁶ See *id.*, §12.1(a); see Cesare, *Private Foundations*, B-301 – B-306 (sample client letter).

³⁵⁷ Code §4942(j)(3); see Hopkins, *Tax Exempt Organizations*, §§12.1(b), 12.4; see Phelan, *Nonprofit Organizations*, §§7:8, 10:23; see Cesare, *Private Foundations*, A-75 – A-81.

³⁵⁸ Code §4942(j)(3)(A); Reg. §53.4942(b)-1; see Hopkins, *Tax Exempt Organizations*, §12.1(b); see Cesare, *Private Foundations*, A-75 – A-78 (income test).

³⁵⁹ Code §4942(j)(3)(B)(i); Reg. §53.4942(b)-2(a); see Hopkins, *Tax Exempt Organizations*, §12.1(b); see Cesare, *Private Foundations*, A-78 – A-79 (asset test).

³⁶⁰ Code §4942(j)(3)(B)(ii); Reg. §53.4942(b)-2(b); see Hopkins, *Tax Exempt Organizations*, §12.1(b); see Cesare, *Private Foundations*, A-79 (endowment test).

support comes from the general public, (2) up to 25% of its support comes from other tax exempt organizations, and (3) up to 50% of its support comes from gross investment income.³⁶¹ A private foundation's articles of organization must have certain provisions.³⁶²

Some private foundations are exempt from the §4940 investment income excise tax.³⁶³ Certain rules apply to special private nonoperating foundations.³⁶⁴ Special rules also apply to foreign exempt organizations.³⁶⁵

- c. *IRS Application Process for 501(c)(3) – Form 1023*³⁶⁶
 - i. *The Importance of the Narrative Description of Activities*

An organization must provide a thorough description of its past, present and planned activity that answers the following questions:

- What is the activity?
- Who conducts the activity?
- When is the activity conducted?
- Where is the activity conducted?
- How does the activity further the organization's exempt purposes?
- What percentage of the organization's time is allocated to the activity?
- How is the activity funded?³⁶⁷

An organization may also provide additional supporting information, including copies of newsletters, brochures, websites or other documents. Although some flexibility in answering the form questions is allowed, the information cannot be vague or unclear, and it has to reflect those activities that determine the tax-exempt status of an organization.³⁶⁸

- ii. *Submitting the Budget: What You Need to Know*

Form 1023 requires that an organization provide financial information for the most recent four tax years, or if the information is not available, provide a reasonable good faith estimate of future finances for the next three years. In making pro-forma financial

³⁶¹ Code §4942(j)(3)(A); Reg. §53.4942(b)-1; see Hopkins, *Tax Exempt Organizations*, §12.1(b); see Cesare, *Private Foundations*, A-75 – A-78 (support test).

³⁶² Code §508(e); Rev. Rul. 70-270; see Webster, *Organization*, A-107.

³⁶³ Code §4940(d)(2); see Cesare, *Private Foundations*, A-80 – A-81.

³⁶⁴ See Cesare, *Private Foundations*, A-83 – A-85.

³⁶⁵ See *id.*, A-87 – A-89.

³⁶⁶ See Rev. Proc. 2013-9 and see Hopkins, *Tax Exempt Organizations*, §26.1(e). See also Rosenthal, *Good Counsel*, 29 (filling out and submitting an IRS tax exempt application works best on a 3-9 month time frame and the organization should retain an accountant or attorney to file for tax exempt status). The 27 month rule holds that tax exempt status is retroactive to an organization's formation under state law if the application is filed within 27 months of the organization's date of incorporation, including retroactive tax deductions for donors. Rosenthal, *Good Counsel*, 30. See the IRS website for Form 1023 (<http://www.stayexempt.irs.gov>). See Phelan, *Nonprofit Organizations*, §7:3.

³⁶⁷ See Phelan, *Nonprofit Organizations*, §7:11.

³⁶⁸ See Hopkins, *Tax Exempt Organizations*, §26.1(a)(iii).

projections, an organization should carefully balance long-term sustainability with its tax-exempt purpose.³⁶⁹

iii. Other Traps for the Unwary

The nonprofit organization must balance between allowing flexibility for future activity the organization may want to conduct, which might cause the IRS to reject the application as hypothetical, and specifically naming the activities it will currently perform.

iv. Retroactive Tax Exempt Applications for Existing Organizations

If an organization files Form 1023 within 27 months of formation, its exemption under Section 501(c)(3) will be effective from the date it was legally formed.³⁷⁰ The 27 month rule now applies to non 501(c)(3) organizations too.³⁷¹ If an organization does not file Form 1023 within 27 months of formation, Schedule E on Form 1023 provides some exceptions that would allow retroactive application to the date of formation. If an organization accepts contributions while its 1023 Form is pending approval, those contributions will be deemed tax deductible only if the tax-exempt status of an organization is approved. An organization must communicate to its donors that it offers no guarantee on the final approval of its tax-exempt status, and while donors may claim deductions in the interim, these deductions can be lost should the application later be rejected.

d. IRS Application Process for Other 501(c) Categories

Organizations that qualify for exemption under any Tax Code section other than 501(c)(3), may file Form 1024 to apply for recognition of exemption under Section 501(a). Those organizations include the following types: 501(c)(2), 501(c)(4), 501(c)(5), 501(c)(6), 501(c)(7), 501(c)(8), 501(c)(9), 501(c)(10), 501(c)(13), 501(c)(15), 501(c)(17), 501(c)(19), and 501(c)(25).

Organizations that are not required to file a federal income tax exemption application may still do so and obtain certain incidental benefits, including public recognition of tax exempt status, state tax exemption, donor assurance and other benefits. These organizations include: churches, including synagogues, temples, and mosques; integrated auxiliaries of churches and conventions or associations of churches.³⁷²

e. Required Annual or Periodic Federal/State/Local Filings

i. Federal Filings³⁷³

1. Form 990 Annual Information Return.³⁷⁴

³⁶⁹ See Phelan, *Nonprofit Organizations*, §7:13.

³⁷⁰ Regs. §§1.508-1(a)(2)(i) (15 months), 301.9100-2 (12 month extension); Webster, *Organization*, A-4.

³⁷¹ Rev. Proc. 2013-9; see Webster, *Organization*, A-4.

³⁷² See Phelan, *Nonprofit Organizations*, §7:1.

³⁷³ See Hopkins, *Tax Exempt Organizations*, Ch. 26.

The tax exempt organization's annual information return, the Form 990, is discussed later in this CLE. The tax exempt organization must make its Form 990s for the last 3 years available to the public.³⁷⁵

2. *Employer's Federal Tax Return to report:*³⁷⁶
 - a. *Income tax withheld and paid for an employee;*³⁷⁷

A common misconception is that a nonprofit's tax exempt status applies to its employees as well. But an individual cannot be a nonprofit or tax exempt organization. So while the nonprofit does not pay income tax on the organization-level income, each employee pays income tax on her wages or other compensation from the nonprofit, so payroll withholding would be appropriate.

- b. *FICA taxes withheld and paid on behalf of an employee: Social Security and Medicare taxes;*³⁷⁸

Along with an individual's income taxes, she must also pay (and have withheld) FICA taxes, better known as Social Security and Medicare taxes, on her wages and compensation from the nonprofit.

- c. *Use Form 941 if quarterly, or Form 940 if annual;*

Form 941 (revised for 2015) is the employer's quarterly tax reporting filed with the IRS. Form 941 does not report the nonprofit organization's income or expenses, but rather employment data, such as number of employees, wages and compensation paid, employment taxes withheld on employees' behalf, and other vital information. Form 940 is the employer's annual tax report filed with the IRS, for the FUTA or unemployment taxes.

3. *Unemployment – FUTA tax;*³⁷⁹

FUTA does not apply to a 501(c)(3) employee's services.³⁸⁰ Instead, states provide unemployment insurance coverage to 501(c)(3) employees.³⁸¹

Employee benefits

³⁷⁴ See Webster, *Trade Associations*, A-47 – A-49.

³⁷⁵ See Phelan, *Nonprofit Organizations*, §7:2; see Hopkins, *Tax Exempt Organizations*, §26.1(a)(i).

³⁷⁶ A tax exempt organization is exempt from federal income tax, but its employees are not exempt from income, FICA, Social Security, Medicare, and related federal, state, and local taxes. See Rosenthal, *Good Counsel*, 30.

³⁷⁷ See Code §§3401-3406.

³⁷⁸ See Code §3101 et seq (Federal Insurance Contributions Act/FICA (1935), includes Social Security and Medicare taxes).

³⁷⁹ See Code §3301 et seq (Federal Unemployment Tax Act/FUTA (1935)).

³⁸⁰ Code §3306(c)(8); see Webster, *Organization*, A-4.

³⁸¹ Code §§3309, 3304(a)(6); see Webster, *Organization*, A-4.

A 501(c)(3) or public educational institution can provide tax deferred annuities to employees.³⁸² Deferred compensation plans are also allowed for state and local employees, along with 501(c)(3) employees.³⁸³ And while a nonprofit does not operate for profit per se, the organization can run a profit sharing plan for employees.³⁸⁴ Tax exempt organizations can provide 401(k) plans for employees.³⁸⁵

ii. *State Filings*³⁸⁶

1. *Annual Report with the Secretary of State;*³⁸⁷

Kansas filing

A Kansas nonprofit must file an annual report at the end of its tax year and a \$40 fee, change of registered office and/or agent and a \$20 fee, and other standard forms with the Kansas Secretary of State, just as a for profit corporation would.³⁸⁸

Missouri filing

A Missouri nonprofit corporation's "corporate registration report" must be filed with the Secretary of State by August 31.³⁸⁹

2. *Employer's State Tax Return;*

Kansas Nonprofits

Kansas provides its various state business tax forms and instructions, some of which a nonprofit may be exempt from paying.³⁹⁰ Kansas offers exemption certificates for various state taxes.³⁹¹

Missouri Nonprofits

³⁸² Code §403(b); see Webster, *Organization*, A-4.

³⁸³ Code §457; see Webster, *Organization*, A-4.

³⁸⁴ Code §401(a)(27); see Webster, *Organization*, A-4.

³⁸⁵ See Webster, *Organization*, A-4.

³⁸⁶ State/local governments offer exemption from sales, use, and property taxes. See Rosenthal, *Good Counsel*, 30.

³⁸⁷ See the Kansas and Missouri Secretaries' websites, (<https://www.kansas.gov/annual-reports/index.do>) and (<https://bsd.sos.mo.gov/login/welcome.aspx?lobID=1>).

³⁸⁸ See the Kansas Secretary's website www.accesskansas.org/annual-reports/index.do. K.S.A. §§17-7504, 17-7910, 17-6204. See Phelan, *Nonprofit Law*, §2:27.

³⁸⁹ V.A.M.S. §355.856.3. A Missouri nonprofit that fails to file a corporate registration report must pay a \$15 fee or dissolve. V.A.M.S. §§355.856.3, 355.706. The corporate registration report is due August 31 of the year after incorporation, and the corporation must continue filing corporate registration reports by August 31 of each succeeding year. See Van Dyke, *Missouri Corporate Practice*, §18-17.

³⁹⁰ See Kansas Department of Revenue website (<http://www.ksrevenue.org/forms-bustax.html>).

³⁹¹ See Kansas Department of Revenue website (<http://www.ksrevenue.org/pecwelcome.html>).

Missouri also provides a variety of state business tax forms and instructions, some of which, again, a nonprofit could be exempt from paying.³⁹² Missouri also has exemptions from various state taxes for nonprofits.³⁹³

iii. Local Filings

1. Withholding taxes, if any for the city, county, or district

A prime example of a local withholding tax is Kansas City, Missouri's city wide 1% earnings tax. Kansas City's earnings tax applies to each employee's wages and compensation, regardless of whether the employer is a nonprofit or a business.

2. Occupational taxes, such as licenses or permits

Examples of occupational taxes including licenses or permits, liquor taxes, tobacco sales taxes, lodging taxes, and others. Local governments are a microcosm of the federalism dynamic seen between the states and federal governments, and a similar patchwork kaleidoscope of local taxes, rules, and municipal code regulations apply to various organizations. The attorney counseling the nonprofit or tax exempt organization should be aware of all local filings, taxes, licenses, or permits required and double check with the nonprofit's accountant and others to ensure the nonprofit is fully compliant.

Conclusion

As attorneys, we serve a vital role in serving the nonprofit, its employees and volunteers, and its donors, throughout the tax exempt application process and the nonprofit's lifecycle.

3. HANDLING DONOR CONTRIBUTIONS AND DEDUCTIONS

When someone gives to a charity, the vast tax law of charitable giving comes into play.³⁹⁴ As attorneys in the nonprofit realm, we will often advise nonprofit organizations or donors to design contributions and guide the corresponding tax deductions. Much charitable giving is driven by striving for the common good, belief in a noble cause, family or friend relationships, or other altruistic motives. Gifts are defined by state law with IRS guidance.³⁹⁵ A charitable contribution has 5 parts: (1) a transfer of (2) money or property (3) to a permissible charity, (4) that is (a) voluntary *and* (b) without receiving economic consideration or benefit, and (5) in the proper form.³⁹⁶

³⁹² See Missouri Department of Revenue website (<http://dor.mo.gov/business/>).

³⁹³ See Missouri Department of Revenue website (<http://dor.mo.gov/faq/business/exempt.php>).

³⁹⁴ Our focus is charitable giving and income tax deductions. See Bruce R. Hopkins, *The Law of Tax Exempt Organizations* (Wiley, 12th ed., 2019), 6.1(c).

³⁹⁵ Reg. §25.2511-1(c); Hopkins, *Charitable Giving*, 289, 8.2(a).

³⁹⁶ Code §170; see Kirschten, *Charitable Contributions*, A-3.

The “tax reason” for charitable giving is an income tax deduction.³⁹⁷ A charitable deduction is allowed for gifts made “to or for the use of” a qualified charity.³⁹⁸ Qualified charities are either public charities or nonpublic charities.³⁹⁹

Public Charities - Code 170(b)(1)(A)

Public charities include churches, hospitals, and schools.⁴⁰⁰ A gift to a public charity receives the maximum income tax deduction, either 30% or 50% of the donor’s contribution base.⁴⁰¹ The 50% maximum income tax deduction or “percentage limit” (in the Code’s parlance) has been with us since 1969.⁴⁰²

The Fifty Percenters

The 50% limit applies to a donor’s contribution base for (a) cash and ordinary income property given to public charities and private operating foundations and (b) capital gain property given to public charities (where the contribution value is reduced by the unrealized appreciation built up in the capital gain property).⁴⁰³ First, in this 50% public charity deduction group are a host of charities such as (1) churches, (2) schools, (3) medical or hospital care or medical research or education organizations, (4) organizations mainly funded by the U.S. or state governments or the public and use their money for educational organizations owned or operated by government agencies, and (5) government units if the gifts are used exclusively for public purposes.⁴⁰⁴

Second, trusts, funds, or foundations like publicly or government funded museums, libraries, community centers, United Funds, and the American Red Cross are also fifty

³⁹⁷ Code §170. See Hopkins, *The Law of Tax Exempt Organizations*, §2.3. If a taxpayer itemizes her deductions, she can claim a charitable deduction on Schedule A (of Form 1040). See Kirschten, *Charitable Contributions*. See Hopkins, *The Tax Law of Charitable Giving*, 3; Beckwith & Allan, *Estate and Gift Tax Charitable Deductions* (Bloomberg BNA No. 839). Code §2522 (gift tax charitable deduction) (Hopkins, 8.2(k), 296-300); Code §2055(a) (estate tax charitable deduction) (Hopkins, 8.3(b), 306-309). The income tax law applies percentage limits to charitable deductions, while estate and gift taxes do not. The types of qualifying deductions also vary slightly. Price, *Estate Planning*, §8.1.

³⁹⁸ Code §170(c); Price, *Estate Planning*, §8.2. The qualified charity list includes five parts: (1) a state or federal government unit, if the gift is for exclusively public purposes, (2) a corporation, trust, community chest, fund, or foundation organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, to foster sports competition, or for the prevention of cruelty to children or animals, (3) war veterans’ organizations or posts, (4) a fraternal organization using the lodge system if the gift is exclusively for religious, charitable, scientific, literary, or educational purposes, to foster sports competition, or for the prevention of cruelty to children or animals, or (5) a nonprofit cemetery company. *Id.* A comprehensive list of 170(c) qualifying organizations is available at (<https://www.irs.gov/Charities-&-Non-Profits/Exempt-Organizations-Select-Check>) and in IRS Pub. 78.

³⁹⁹ Code §§170(b)(1)(A) or 509(a)(1), (2), or (3) organizations; Price, *Estate Planning*, §8.3 (“public charities”); *Id.*, 8.4 (“nonpublic charities”).

⁴⁰⁰ Price, *Estate Planning*, §8.2.

⁴⁰¹ Price, *Estate Planning*, §8.2. A donor’s “contribution base” is adjusted gross income, not including NOL carryback under 172). Code §170(b)(1)(F).

⁴⁰² Price, *Estate Planning*, §8.3; see Hopkins, *Tax Exempt Organizations*, §2.3.

⁴⁰³ Code §§170(b)(1)(A), 170(b)(1)(C)(iii); see Hopkins, *Tax Exempt Organizations*, §2.3.

⁴⁰⁴ Code §§170(b)(1)(A)(i)-(v); Price, *Estate Planning*, §8.3.

percenters if they receive a substantial amount of funds from (a) the government or (b) public.⁴⁰⁵

Third, three kinds of private foundations qualify as fifty percenters – (1) private operating foundations, (2) private nonoperating foundations that distributes all contributions to public charities or other qualifying distributions within 2.5 months after its tax year closes, and (3) a private foundation that pools donations in a common fund and allows contributors (or spouses) to designate public charities to receive annual income and their donation portion of the fund.⁴⁰⁶

Fourth, 509(a)(2) or (a)(3) organizations are public charities for fifty percenter purposes.⁴⁰⁷ If an organization fits under 509(a)(1), (2), or (3) it's not a private foundation, so it's free to paying the private foundation excise taxes.⁴⁰⁸ A 509(a)(2) organization has broad public support, so over 1/3 of its money comes from gifts, grants, contributions, or membership fees, and under 1/3 of its money from gross investment income.⁴⁰⁹ By contrast, a 509(a)(3) organization a/k/a a “supporting organization” is organized and operated exclusively to support one or more specific public charities and is not directly or indirectly controlled by a donor or “disqualified person.”⁴¹⁰

Thirty Percenters

The 30% limit applies to a donor's contribution base for (a) capital gain property given to public charities and (b) cash and ordinary income property given to private foundations.⁴¹¹

Twenty Percenters

The 20% limit applies to a donor's contribution base for capital gain property given to nonpublic charities, operating foundations, and private foundations.⁴¹²

So what if a generous donor gives more than her percentage limit to a charity for the year? She can carry over the excess donation amount for 5 years.⁴¹³ Or is she gives cash

⁴⁰⁵ Code §§170(b)(1)(A)(vi) (these are “509(a)(1) organizations); 170(c)(2) (qualifying foundations); Price, *Estate Planning*, §8.3.

⁴⁰⁶ Code §170(b)(1)(E); Code §4942(j)(3), Reg. §53.4942(b)-1, §53.4942(b)-2 (type 1); Reg. §1.170A-9(g) (type 2); Reg. §1.170A-9(h) (type 3). Private foundations give a range of donors “very attractive benefits,” where a donor has “long term charitable objectives” and “wishes to exert control over the charitable activity to fulfill a very specific intent” and “is willing to accept greater limits on income tax deductions and stringent limit[s]” on the foundation's operation. Price, *Estate Planning*, §8.42.10.

⁴⁰⁷ Code §170(b)(1)(A)(viii); Price, *Estate Planning*, §8.3.

⁴⁰⁸ Code §§4940-4948; Price, *Estate Planning*, §8.3. The private foundation excise tax rules (§§4940-4945) were added in 1969 to curb perceived private foundation abuses. Price, *Estate Planning*, §8.42.6.

⁴⁰⁹ Reg. §1.509(a)-3; Price, *Estate Planning*, §8.3.

⁴¹⁰ Reg. §1.509(a)-4; Price, *Estate Planning*, §8.3. Supporting organizations are helpful tools since they are public charities for income tax purposes without incurring private foundation excise taxes or other rules. Price, *Estate Planning*, §8.3.

⁴¹¹ Code §§170(b)(1)(C)(i), 170(b)(1)(B); see Hopkins, *Tax Exempt Organizations*, §2.3.

⁴¹² Code §170(b)(1)(D); see Hopkins, *Tax Exempt Organizations*, §2.3.

⁴¹³ Code §§170(b)(1)(C)(ii), 170(d)(1)(A); see Hopkins, *Tax Exempt Organizations*, §2.3.

or ordinary income property to a private foundation, the 5 year carryover rule also applies (for gifts over the 30% limit).⁴¹⁴

Nonpublic Charities

For nonpublic charities (a catchall category for anything that's not a public charity), a 30% income tax deduction limit applies.⁴¹⁵ This includes charities listed in §170(c), like cemetery companies, war veterans' posts or organizations, fraternal lodges, and private nonoperating foundations, as well as gifts made *for the use of* a public charity.⁴¹⁶

If a donor gives a gift to a private foundation or a nonpublic charity, she can deduct the lesser of (a) 30% of her yearly contribution base or (b) the excess of 50% of her contribution base over her gift amount to public charities.⁴¹⁷ In the nonpublic charity realm, the thirty percenter group includes a gift "for the use of" a nonpublic charity.⁴¹⁸

A. Types of Gifts: Advising Clients on Accepting Money and Property

A charitable gift's tax law treatment depends on (1) what kind of gift is given and (2) the charity's federal tax law type.

Gifts

The income tax law recognizes two kinds of gifts: (1) money gifts or (2) property gifts.⁴¹⁹ Money gifts includes cash, payments by check or credit card, promissory notes, letters of credit, pledges, options, and interest free loans.⁴²⁰ Property gifts can be: (1) ordinary income property or (2) capital gain property.⁴²¹ In taxes, as with business, timing is everything. A gift usually counts as of delivery.⁴²² A note given to a charity is a "mere promise to pay" and not deductible until paid.⁴²³ A money pledge to a charity is deductible when paid, not when pledged.⁴²⁴ But money given to a charity via the donor's bank credit card is deductible when given.⁴²⁵ Using a similar "mailbox rule" chestnut from the contract law, a gift by check is completed when mailed or delivered, and a gift by credit card is complete the day the charge is authorized.⁴²⁶ Conrad Teitell helpfully summarized the nuances of the IRS' gift completion rules.⁴²⁷

⁴¹⁴ Code §170(b)(1)(B); see Hopkins, *Tax Exempt Organizations*, §2.3.

⁴¹⁵ Price, *Estate Planning*, §8.2.

⁴¹⁶ Price, *Estate Planning*, §8.2.

⁴¹⁷ Code §170(b)(1)(B); Price, *Estate Planning*, §8.4.

⁴¹⁸ Price, *Estate Planning*, §8.4.

⁴¹⁹ See Hopkins, *Charitable Giving*, 240, §7.1(a); see Kirschten, *Charitable Contributions*, A-6 – A-11 (money), A-11 – A-15 (property).

⁴²⁰ See Kirschten, *Charitable Contributions*, A-6 – A-7.

⁴²¹ Code §170(e)(1)(A); see Kirschten, *Charitable Contributions*, A-115 – A-118 (ordinary income property). See Kirschten, *Charitable Contributions*, A-12 – A-15 (capital gain property).

⁴²² Reg. §1.170A-1(b); Price, *Estate Planning*, §8.6.

⁴²³ Rev. Rul. 68-174; Price, *Estate Planning*, §8.6.

⁴²⁴ *Mann v. IRS*, 35 F.2d 873 (D.C. Cir. 1929); Rev. Rul. 78-129; Price, *Estate Planning*, §8.6.

⁴²⁵ Rev. Rul. 78-38; Price, *Estate Planning*, §8.6.

⁴²⁶ Price, *Estate Planning*, §8.6.

⁴²⁷ Teitell, *Taxwise Giving* 8-9 (2001); Price, *Estate Planning*, §8.6.

An income interest gift is a gift “for the use of” a charity.⁴²⁸ But a remainder interest gift is a gift to the charity, unless the remainder is held in trust after the prior interests end (then the gift would be “for the use of” the charity).⁴²⁹

Ordinary Income vis-à-vis Capital Asset

We arrive at one of the foundational touchstones of accounting and tax law. A capital asset is property owned, regardless of any trade or business connection.⁴³⁰ The capital asset definition is broad and sweeping: an ordinary income asset is defined by exclusion.⁴³¹ Ordinary income assets include: (a) stock in trade, inventory, or property held for sale to customers in the ordinary course of trade or business, (b) a note or account receivable from services rendered or goods sold, (c) depreciable business property, (d) real estate used in the trade or business, (e) intellectual property (not a patent or invention) held by its creator, (f) a U.S. Government publication, (g) derivative financial instruments, (h) hedging transactions in the course of business, (i) business supplies.⁴³² Capital assets include gain from the sale of a donor’s furniture, house, or vehicle. But a capital loss is not recognized unless the property was held for income production.⁴³³ Stocks and securities are capital assets since they are owned for income production. A securities future contract could be a capital asset.⁴³⁴

Since capital assets are broadly interpreted, a noncapital asset or ordinary income asset needs to fall within the above categories to count as ordinary income property.⁴³⁵

And within the capital gain asset realm, there are two kinds of capital gain property: (1) short term capital gain property and (2) long term capital gain property.⁴³⁶ Short term capital assets are owned for under one year; long term capital assets are owned for over one year. A donation of ordinary income property or short term capital gain property is treated “the same as gifts of money.”⁴³⁷ Long term capital gain property plays by different rules and is often called capital gain property or 30 percent capital gain property.⁴³⁸

Second, the charity’s tax law type. Various charity types include: public charity, semi public charity, private operating foundations, and private nonoperating foundations.⁴³⁹

⁴²⁸ Code §170; Price, *Estate Planning*, §8.4.1.

⁴²⁹ Reg. §1.170A-8(a)(2); Price, *Estate Planning*, §8.4.1.

⁴³⁰ Code §1221; Reg. §1.1221-1.

⁴³¹ Code §§170(b)(1)(C)(iv), 1222(1), (2); see Rothman et al, *Capital Assets* (Bloomberg BNA No. 561); see Hopkins, *Tax Exempt Organizations*, §2.3.

⁴³² See Hopkins, *Tax Exempt Organizations*, §2.3.

⁴³³ Reg. §1.262-1(b)(4).

⁴³⁴ Code §1234B.

⁴³⁵ *Arkansas Best Corp. v. IRS*, 485 U.S. 212 (1988); *Corn Products Refining v. IRS*, 350 U.S. 46 (1955).

⁴³⁶ Code §§1245, 1250; Hopkins, *Charitable Giving*, 240, §7.1(a); see Kirschten, *Charitable Contributions*, A-121.

⁴³⁷ Hopkins, *Charitable Giving*, 240, 7.1(a).

⁴³⁸ Reg. §1.170A-8(d)(3); Hopkins, *Charitable Giving*, 240, §7.1(a).

⁴³⁹ See Kirschten, *Charitable Contributions*, A-129 – A-138

This seminar assumes an individual gives a gift to a charitable organization.⁴⁴⁰ No charitable deduction is allowed for performance of services, transfers of permits, some IRA or donor advised fund (DAF) contributions, or constructive dividends.⁴⁴¹ But a donor can deduct unreimbursed expenses incurred in connection with performing free services for a charity, and these unreimbursed expenses are made “to,” not “for the use of,” the charity.⁴⁴²

B. Handling Unanticipated Funds with “Facts and Circumstances” Test

By definition, public charities need a broad base of donor support.⁴⁴³ But what if a public charity gets a large grant or gift that jeopardizes the charity’s broad donor support base?⁴⁴⁴ Unless the charity received an “unusual grant” or “material changes in support,” the public charity might lose its tax exempt status.

Unusual Grant

An unusual grant is a substantial contribution or gift from a donor who is (1) attracted by the organization’s publicly supported nature, (2) of unusual or unexpected amounts, and (3) capable of adversely affecting the organization’s broadly publicly supported status because of the gift’s size.⁴⁴⁵ The unusual grant exception allows an unusual grant to be taken out of the support test fraction entirely, so a charity that receives an unusual grant should be favorably viewed by the charity.

Quirky/Not Uncommon vs. Unusual

IRS rules help decide if a grant is an unusual gift. A grant or gift that alters a publicly supported organization’s status is an unusual grant if: (1) it’s not made by someone who (a) created the organization, (b) was a substantial contributor to the organization, or (c) is a disqualified person as to a creator or substantial contributor, (2) it’s not made by (a) someone in a position of authority, (b) who can exercise control over the organization, (c) who obtains an authority or control position from the grant, or (d) is a disqualified person in these circumstances, (3) the grant or contribution is in (a) cash, (b) marketable securities, or (c) assets that directly further the organization’s exempt purposes, (4) the organization has received an advance or final ruling or publicly supporting organization determination letter unless the organization is (a) operating under an advance ruling or determination letter or (b) actively engaged in an activity program which furthers its

⁴⁴⁰ For gifts by charitable remainder trusts, pooled income funds, charitable gift annuities, and other planned giving techniques, see Hopkins, *Charitable Giving*, Chs. 12 (charitable remainder trusts or CRTs), 13 (pooled income funds), and 14 (charitable gift annuities).

⁴⁴¹ See Kirschten, *Charitable Contributions*, A-15 – A-17. For donor advised funds, see Kirschten, *Charitable Contributions*, A-216 – A-224. For IRAs, see Price, 8.1. Price 8.4.1 (service gifts).

⁴⁴² Rev. Rul. 84-61; *Rockefeller v. IRS*, 676 F.2d 35 (2nd Cir. 1982); Price, *Estate Planning*, §8.4.2. Mileage incurred for the charity by the donor is deductible at 14 cents per mile. Code §170(i); Price, *Estate Planning*, §8.4.2. But travel expenses are not deductible if for pleasure, recreation, or vacation. Code §170(k); Price, *Estate Planning*, §8.4.2.

⁴⁴³ See Lauren W. Cesare, *Private Foundations and Public Charities: Definition and Classification* (Bloomberg BNA No. 456, 2015); see Price, *Estate Planning*, §8.4.2. Gifts to private foundations afford unlimited gift and estate tax deductions. Code 2055(a), 2522(a); Price, *Estate Planning*, §8.4.2.

⁴⁴⁴ Code §§509(a)(1) (broadly supported by contributors) and 509(a)(2) (broadly support for services and/or membership dues).

⁴⁴⁵ Regs. §§1.170A-9(f)(6)(ii); 1.509(a)-3(c)(3).

exempt purpose, (5) no material restrictions or conditions were imposed by the grantor or contributor in connection with the grant or contribution, and (6) grantors or contributions designed to underwrite operating expenses (not capital financing) supply up to one year's operating expenses.⁴⁴⁶

If the organization has a question about whether it is indeed an unusual grant, the organization can request a ruling from the IRS, by filing a request with the District Director and the IRS can issue a ruling in its sole discretion.⁴⁴⁷

Material Changes in Support

Jane Smith wins the lottery, receives a large inheritance, or turns a novel idea into a fortune. Jane has always been an avid supporter of a local public charity. Now she can afford large donations. Enter the public charity's Sword of Damocles: material changes in support.

Material changes of support raise the spectre that a nonprofit may not be able to continue operating as a public charity.

Route One

For the first route, tax law provides several helpful pointers:

- An organization's status is unaffected until the material change in support is made public. A grantor or donor should presume an organization is a public charity until the IRS issues a contrary public notice. – same or new donor?
- A grantor or donor whose donation or gift causes a material change in support doesn't get the income tax deduction from the contribution to a public charity.
- A grantor or contributor who makes the grant or contribution when relying on a written statement signed by the organization's officer is not responsible for the material change in support. The written statement must contain financial data for the four prior years that would assure a reasonably prudent grantor that her contribution will not alter the organization's publicly supported status.⁴⁴⁸

Route Two

For the second route, the grantor or contributor isn't responsible for a material change in the organization's support if the aggregate of her gifts, grants, and contributions to the organization during the tax year is 25% or less of the organization's support for the four prior tax years. For a relatively new organization (in existence less than 5 tax years), the organization's life span so far is the test as long as the new organization has existing for a tax year of at least eight months. An organization's support over the 4 year or short period (as described above) does not include any support from the donor or any person that (1) owns over 20% of (a) a donor corporation's total combined voting power, (b) a

⁴⁴⁶ Regs. §§1.509(a)-3(c)(4); 170A-9(f)(6)(iii).

⁴⁴⁷ Rev. Proc. 2011-4.

⁴⁴⁸ Treas. Reg. §1.170A-9(f)(4)(v); Rev. Proc. 81-6[?].

donor partnership's profit interest, or (c) a donor trust or unincorporated enterprise's beneficial interest, (2) a spouse, ancestor, child, grandchild, great grandchild, or spouse of a donor or person described in (1), or (3) is a corporation, partnership, estate, or trust where the donor, with anyone in (1) or (2) owns over 3.5% of the total voting power, profits interest, or beneficial interest.⁴⁴⁹

C. Tax Deductions and Substantiation Requirements

1. Limited Income Tax Deductions

Percentage limits are complex, but arise from the progressive income tax logic – a high income donor should not be able to avoid paying income taxes by giving away all her income. So the Tax Code imposes a percentage limit on how much a taxpayer can deduct in a given tax year from her annual income, depending on three things: (1) the kind of organization she donates to, (2) the type of property she donates, and (3) whether the donation is to (a) a charity or (b) for the charity's use.

*Cash and Ordinary income contributions*⁴⁵⁰

- a. **Percentage Limits.** A percentage limit is a deduction limit. The IRS Code imposes “percentage limitations” on charitable contributions by individual donors, to wit – an individual may only deduct up to the “percentage limitation” vis-à-vis gross income for the tax year.⁴⁵¹ The percentage limits can be 50, 30, and/or 20% of the individual's contribution base.⁴⁵² The applicable percentage limit hinges on (1) the kind of gift and (2) the charity's tax classification.

We briefly survey the broad brushstrokes of the percentage limits canvas before we focus in on the finer elements/gradients. The 50% limit applies to gifts of money to public charities, some tangible personal property gifts, private operating foundations, and 3 types of private nonoperating foundations.⁴⁵³ The 30% limit applies when (1) the gift is capital gain property (2) to a public charitable organization.⁴⁵⁴ The 30% limit also applies to certain money donations to private foundations, veterans' organizations, and fraternal organizations.⁴⁵⁵ The 30% limit further applies to semi public charities, private foundations, and contributions “for the use of” any charity, and capital gain property to public charities, and remainder trust interests.⁴⁵⁶ The 20% limit applies to capital gain property

⁴⁴⁹ Rev. Proc. 81-6; see Kirschten, *Charitable Contributions*, A-138.

⁴⁵⁰ The contribution amount for ordinary income property is limited to the contributed property's cost, not the property's fair market value. Code §170(e)(1).

⁴⁵¹ Code §170(e)(1)(A); see Kirschten, *Charitable Contributions*, A-128 – A-129.

⁴⁵² Reg. §1.170A-8(a)(1); Hopkins, *Charitable Giving*, §7.4(a), 244.

⁴⁵³ Code §170(b)(1)(A); Reg. §1.170A-8(b); Hopkins, *Charitable Giving*, §7.4(a), 244; see Kirschten, *Charitable Contributions*, A-128.

⁴⁵⁴ Code §170(b)(1)(C)(i); Hopkins, *Charitable Giving*, §7.4(a), 244; see Kirschten, *Charitable Contributions*, A-129.

⁴⁵⁵ Code §170(b)(1)(B)(i); Hopkins, *Charitable Giving*, §7.4(a), 245.

⁴⁵⁶ Code §170(b)(1)(c); Rev. Rul. 79-368.

donations to private foundations or other organizations.⁴⁵⁷ The 10% limit applies to a corporation's charitable giving.⁴⁵⁸

- i. **Contribution Base.** An individual donor can claim up to 50% of the individuals' "contribution base"⁴⁵⁹ for donations to "public charities,"⁴⁶⁰ which are called "50 percent organizations."⁴⁶¹ The donor's "contribution base" is her adjusted gross income.⁴⁶² Contrary to some popular ideas, an individual cannot donate all her income to charity to avoid paying income taxes: indeed, the maximum charitable deduction allowed by the IRS is 50% of her contribution base.⁴⁶³

50% Limit

The 50% limit applies to five gifts: (1) money gifts, (2) ordinary income property gifts, (3) short term capital gain property gifts, (4) some capital gain property gifts, and (5) capital gain property gifts where a special election is made.⁴⁶⁴

Caveats. A donor's contributions of:

- (1) certain appreciated property to 50 percent organizations are subject to special rules
- (2) Contributions in trust "for the use of" (not "to") the charity do fail the 50 percent deduction test.⁴⁶⁵

50% limit organizations include: public charities, churches, some educational organizations, some hospital or medical research organizations, university endowment funds, some government entities, public supporting organizations (under 509(a)(1)), 509(a)(2)(3) organizations, private operating foundations, and private nonoperating foundations.⁴⁶⁶

⁴⁵⁷ Code §170(b)(1)(D)(i); Hopkins, *Charitable Giving*, §7.4(a), 245; see Kirschten, *Charitable Contributions*, A-129.

⁴⁵⁸ Code §170(b)(2)(A); Hopkins, *Charitable Giving*, §7.4(a), 245.

⁴⁵⁹ An individual donor's "contribution base" is adjusted gross income (AGI) without including any NOL carryback for the year. Code §§62 (AGI), 172 (NOL carryback), 170(b)(1)(F) (contribution base); Reg. §1.170A-8(e).

⁴⁶⁰ Code §170(b)(1)(A).

⁴⁶¹ See Hopkins, *Charitable Giving*, §7.2, 243. A corporation's percentage limits, derived from its taxable income, are beyond this seminar's scope. Hopkins, *Charitable Giving*, §7.3, 243; §7.18, 280ff.

⁴⁶² Code §170(b)(1)(G); see Hopkins, *Tax Exempt Organizations*, §2.3.

⁴⁶³ See Hopkins, *Charitable Giving*, §7.5, 246.

⁴⁶⁴ See Hopkins, *Charitable Giving*, §7.5(a), 247-248.

⁴⁶⁵ Reg. §1.170A-8(a)(2). Contributions to 30 percent organizations (private nonoperating foundations) or "for the use of" a charity are limited to the lesser of (a) 30% of the donor's contribution base or (b) the donor's 50% contribution base after subtracting contributions to 50% organizations. Code §170(b)(1)(B). Nondeductible amounts left over after applying these limits can be carried forward 5 years. Code §170(d).

⁴⁶⁶ See Kirschten, *Charitable Contributions*, A-130 – A-137.

30% Limit

The 30% limit applies to money gifts to non public charitable organizations.⁴⁶⁷ Semi public charities and private foundations (under 509(a)) are 30% limit organizations.⁴⁶⁸

20% Limit

A donor's capital gain property donations to a nonpublic charitable organization qualify her for the 20% limit.⁴⁶⁹

Long Term Capital Gain Property to 50% Organizations

Percentage Limit. For long term capital gain property contributions to 50% organizations, a donor is limited to 30% of the donor's contribution base if valuing the contribution at fair market value.⁴⁷⁰

Long Term Capital Gain Property to 30% Organizations (Private Non Operating Foundations)

- A. Percentage Limit. The donor's percentage limit is the lesser of (a) 20% of the donor's contribution base or (b) what's left of the 30% contribution base after subtracting contributions of long term capital gain property to 50% organizations.⁴⁷¹ And these contributions are automatically reduced to basis when the contribution is to a private non operating foundation, but not other 30% organizations.⁴⁷²

Unrelated Use Contributions (of Tangible Personal Property)

For tangible personal property contributions held for over one year (e.g. long term capital gains treatment) donated to a charity, where the property's use is unrelated to the charity's exempt purpose or function, special rules apply.⁴⁷³ The contribution amount is reduced by the long term capital gain amount that would have applied if the taxpayer sold

⁴⁶⁷ Code §170(b)(1)(B)(i); see Hopkins, *Charitable Giving*, §7.8(a), 263.

⁴⁶⁸ See Kirschten, *Charitable Contributions*, A-137 – A-138.

⁴⁶⁹ Code §170(b)(1)(D)(i); see Hopkins, *Charitable Giving*, §7.12, 268.

⁴⁷⁰ Code §170(b)(1)(C)(i); Reg. §1.170A-1(c)(2). The donor can capture the full 50% limit of the contribution base by electing to reduce the deduction amount by the long term gain taxable if the property was sold for fair market value. Code §170(b)(1)(C)(iii). In weighing this election, the donor should consider the 5 year carryover rules. Code §170(d)(1); Price, *Estate Planning*, §8.5. If the property has little appreciation, reducing the deduction to the property's basis is wise if (a) the donor dies soon after contributing the property (so no carryover years would exist) or (b) when the donor has little or no contribution base for future tax years due to reduced income (e.g. retiring). See Kirschten, *Charitable Contributions*, A-111 – A-114, A-138.

⁴⁷¹ Code §170(b)(1)(D).

⁴⁷² Code §170(e)(1)(B)(ii). This reduction is made before the percentage limit is calculated, but does not apply to "qualified appreciated stock" (e.g. publicly traded on a stock exchange) contribution to private nonoperating foundations. Code §170(e)(5). But the "qualified appreciated stock" exception does not apply if the donor and related family members donate (in total/aggregate) over 10% of a corporation's stock. Code §170(e)(5)(C). See Kirschten, *Charitable Contributions*, A-139.

⁴⁷³ See Kirschten, *Charitable Contributions*, A-140.

the property for fair market value.⁴⁷⁴ This special rule applies to both 50% and 30% organization contributions.⁴⁷⁵

Charity Sells Tangible Personal Property Within 3 Years of the Donation

If the charity sells, exchanges, or disposes of tangible personal property within 3 years of the donor's contribution, the donor must recapture the deduction beyond the donor's basis where the donation is more than \$5,000 of the claimed amount.⁴⁷⁶ The 3 year notification rule applies if the charity transfers the donated property to another charity and the charity recipient must give the IRS chain of title information.⁴⁷⁷ Anyone who knowingly (and incorrectly) identifies property as exempt use property owes a \$10,000 penalty.⁴⁷⁸ The IRS has provided some guidance on when a use is related to a charity's exempt purpose or function.⁴⁷⁹ Lest an enterprising donor clean out their closet or living space in search of phantom donations, no deduction is allowed for clothing or household items unless they are in good used condition or better, and even so, the items must be of more than *de minimis* value.⁴⁸⁰ But the taxpayer is safe where a deduction of \$500 or more is claimed for an item with a qualified appraisal attached to the taxpayer's tax return.⁴⁸¹

Vehicle Donations

For any plane, automobile, or car valued at over \$500, the deduction is (a) limited to the charity's gross proceeds upon selling the vehicle and (b) requires the charity to so inform the donor in writing within 30 days of selling the vehicle.⁴⁸² But if the charity wants to

⁴⁷⁴ Fair market value is the touchstone for contributions to various organizations and different donation types. See Hopkins, *Tax Exempt Organizations*, §2.3.

⁴⁷⁵ Code §170(e)(1)(B)(i).

⁴⁷⁶ Code §§170(e)(7)(A)-(C), 6050L(a); Reg. §1.6050L-1. To avoid this three year disposal rule, the charity can make a "certification," a written statement signed by the charity's officer under perjury penalty that (a) certifies the (1) property's use was "substantial" and related to the charity's purpose or function and (2) describing how the property was used and how that use furthers the charity's purpose or function, or (b) stating the charity's intended use at the contribution time and certifying the use has now become impossible or infeasible. Code §170(e)(7)(D). The charity must also file an IRS return upon disposition. Code §6050L. The charity files Form 8282 with the IRS and the donor to report this information, and Form 8283 is in play too for donations over \$5,000. Charities should retain copies of Forms 8282 and 8283 for 3 years to ensure charity and donor compliance. This IRS notification rule applies to non publicly traded securities donations when the donor's claimed contributions plus similar items donated by the donor to one or more charities is over \$5,000. Code §6050L(a)(2). This notification rule applies for 3 years. And if the charity makes the related use statement, the certification must be provided to the donor when the contribution is made. Code §§6050L(a)(1)(F), (G). The notification alerts the IRS that the donor doesn't owe any recapture. Hopkins, *Charitable Giving*, §24.10, 871-874. See Kirschten, *Charitable Contributions*, A-201.

⁴⁷⁷ Reg. §1.6050L-1(c).

⁴⁷⁸ Code §6720B.

⁴⁷⁹ See PLR 8143029. But PLRs cannot be cited as precedent to the IRS or courts. Code §6110(k)(3).

⁴⁸⁰ See Hopkins, *Charitable Giving*, §21.7, 807. A deduction for a donation of clothing or a household item that is *not* in good used condition is allowed only if (1) more than \$500 is claimed for one item and (2) a qualified appraisal is attached to the donor's tax return.

⁴⁸¹ Code §170(f)(16); see Hopkins, *Charitable Giving*, §21.7, 807.

⁴⁸² Code §170(f)(12). Tax law details the written acknowledgment's content. Code §170(f)(12)(B). See Hopkins, *Charitable Giving*, §24.8, 868.

use (significant intervening use?) or materially improve the vehicle, rather than sell it, a different acknowledgment is used (due to the donor within 30 days of the donation).⁴⁸³

A donor can take her full donation if the charity sells her vehicle to a needy person for much less than fair market value or gives the needy person her car. But this only applies where the vehicle is sold to or given to a poor, distressed, or underprivileged person who needs transportation, and where the charity's gift or sale furthers the charity's purpose.⁴⁸⁴ The IRS has battled with some charities about perceived vehicle donation abuses.⁴⁸⁵ An auction sale of a donated vehicle sets fair market value, so the charity's gross proceeds from auctioning the vehicle become the charitable deduction's value. And the charity's gross proceeds from the auction price must be used when by the donor when taking the charitable deduction. The donor could claim a deduction over \$500 only so far as (a) the gross proceeds exceed \$500 and (b) the donor substantiates her contribution using an acknowledgment listing gross proceeds.⁴⁸⁶

Intellectual Property Gifts

A donor can give a charity of gift of qualified intellectual property – a copyright, trademark, or patent.⁴⁸⁷ The donor may be required to file Form 8899, which includes various requirements.⁴⁸⁸

Fractional Gifts or Partial Interests

No charitable deduction is allowed for an undivided part of the donor's entire tangible personal property interest unless the (a) donor or the (b) donor and the charity hold all property interests before the donation.⁴⁸⁹ A charitable deduction for any additional fractional interest contribution is limited to the lesser of (a) the property's fair market value at the initial fractional contribution or (b) the fair market value when the additional fractional interest contribution occurs.⁴⁹⁰ Any appreciation in the additional fractional interest contribution is ignored, but depreciation in the fractional interest contribution is included.

⁴⁸³ Code §170(f)(12)(B)(iv). And the written acknowledgment is filed with the IRS. Code §170(f)(12)(D). But donated *inventory* is exempt from these rules. Code §170(f)(12)(E)(last sentence). See Kirschten, *Charitable Contributions*, B-1901 – B-1902.

⁴⁸⁴ Notice 2005-44. But simply giving the needy person the vehicle's sale proceeds fails the test.

⁴⁸⁵ IR-2005-145.

⁴⁸⁶ Notice 2007-70.

⁴⁸⁷ Code §§170(m), 882(b), 6050L(b); see Hopkins, *Charitable Giving*, §9.28, 457-461, §24.9, 870-871; see Reddy, *Intellectual Property: Acquisition, Development, and Ownership* (BNA No. 557); see Reddy, *Intellectual Property: Exploitation and Disposition* (BNA No. 558); see Kirschten, *Charitable Contributions*, A-203 – A-204, B-901 (donor letter).

⁴⁸⁸ See Hopkins, *Charitable Giving*, §24.9, 870-871.

⁴⁸⁹ Code §170(o)(1). But the IRS can make exceptions where everyone holding an interest in the gifted tangible personal property makes a proportional contribution of their entire respective property interest. Code §170(o)(1). See e.g. Hopkins, *Charitable Giving*, Ch. 15. A fractional interest can involve (1) dividing up a present interest in property between a charity and one or more other parties or (2) splitting a present interest from a future interest. Dividing up a present property interest is conceptually similar to making a charity a joint tenant or tenant in common with a third party. See Kirschten, *Charitable Contributions*, A-75 – A-110, A-123 – A-124.

⁴⁹⁰ Code §170(o)(2).

For fractional gifts to avoid the IRS recapturing the donor's income tax deduction, two conditions must be satisfied. First, the charity must have complete ownership of the tangible personal property within the sooner of (a) 10 years or (b) upon the donor's death. Second, the charity must have substantial physical possession of the gifted tangible personal property during the time frame of the first condition. But again, if either or both of the conditions are not satisfied, the IRS can recapture the donor's deduction, along with collecting interest and a 10% tax addition.⁴⁹¹

2. *Substantiating Contributions.*

A donor lists her annual charitable contributions on Schedule A (of Form 1040). All organizations must keep records of each contribution received, but appraisal requirements are imposed for some large contributions (but not cash or publicly traded securities, which are simple to value).⁴⁹² The landscape of record keeping and substantiation requirements arises from four IRS Code provisions, added in 1984.⁴⁹³ And the reporting and substantiation rules grew for charitable property contributions starting in 2004.⁴⁹⁴ Indeed, this landscape is a tapestry of five intertwining threads of rules.⁴⁹⁵

A. Recordkeeping. The benchmark of good record keeping is a written communication of some form showing (1) the charity's name, (2) the contribution date, and (3) the contribution amount.⁴⁹⁶

Cash Donations

A donor will not receive a deduction for her cash, check, or money gift unless she keeps a record of the donation via a bank record of written communication from the charity showing (1) the charity's name, (2) the contribution date, and (3) the contribution amount.⁴⁹⁷ The charity must provide the donor with the substantiation a la written communication on or before the earlier of (a) the date the donor files her tax return or (b) the due date, including extensions, for the donor's tax return.⁴⁹⁸ Viewing charitable giving through this tax driven lens means putting cash into the church's offering plate or the Salvation Army's red kettle at the store are usually not deductible.⁴⁹⁹

⁴⁹¹ Code §170(o)(3).

⁴⁹² See e.g. Hopkins, *Charitable Giving*, Ch. 21; see Kirschten, *Charitable Contributions*, A-153 – A-198.

⁴⁹³ Code §§170(f)(8), (11), (16), and (17); see Hopkins, *Charitable Giving*, §21.1, 780; Price, *Estate Planning*, §8.7.

⁴⁹⁴ Code §§170(f)(11)-(12); Price, *Estate Planning*, §8.7.

⁴⁹⁵ The five threads of rules are about: (1) money contributions record keeping, (2) \$250 or more gift substantiation, (3) noncash charitable contribution reporting and substantiation, (4) qualified appraisal and qualified appraiser rules, and (5) clothing and household item contribution appraisal rules. See Hopkins, *Charitable Giving*, §21.1, 780.

⁴⁹⁶ See Kirschten, *Charitable Contributions*, A-205 – A-215.

⁴⁹⁷ Code §170(f)(17); IRS Pub. 526. Prop. Reg. §§1.170A-15(b)(2) ("bank records"); 1.170A-15(b)(3) ("written communication" includes email); see Hopkins, *Charitable Giving*, §21.2, 780-781.

⁴⁹⁸ Prop. Reg. §1.170A-1(c); see Hopkins, *Charitable Giving*, §21.2, 781; see Kirschten, *Charitable Contributions*, B-301 (donor letter), B-501 (real estate letter), B-1801 (gift acknowledgments).

⁴⁹⁹ This evokes the considerable asymmetry between income tax deductions and charitable giving – donors often give money to organizations (or individuals) whose work they appreciate without expectation of any tax deduction. Code §170(f)(17); Price, *Estate Planning*, §8.7.1. Americans have also long been a fundamentally generous, giving, decent people.

Payroll Donations

Importantly for many employees whose employers match their charitable giving or for employees who give to charity through their paycheck, a payroll donation can be substantiated via a (a) pay stub or Form W-2 and (b) a pledge card or similar document showing the charity's name.⁵⁰⁰ For a payroll donation of over \$250 (as with other donations in excess of \$250), a statement that no goods or services were received in exchange for the payroll donation is required.⁵⁰¹

United Way Campaigns

For United Way or similar giving campaigns, the giving campaign must give the donor a written statement with the charity's name contribution amount. For United Way campaign contributions over \$250, the usual \$250 rules apply.⁵⁰²

Noncash Donations Under \$250

When a donor gives a non cash contribution (e.g. clothes or furniture), the charity gives the donor a letter, written communication, or receipt showing the familiar three elements: (1) the charity's name, (2) the contribution date and location, and (3) a detailed description (not the value) of the contribution the contribution amount.⁵⁰³ But what if the donor isn't able to get a receipt, say for a donation after hours or a donation at an unattended drop off site? The donor can use their own written records where obtaining a receipt is impractical.⁵⁰⁴ Beyond receipts, the donor should keep other written records as needed to substantiate her deduction – basis, purchase, or other records.⁵⁰⁵ For a non cash donation between \$250 and \$500, the donor needs a contemporaneous written acknowledgement of the gift.⁵⁰⁶ Indeed, for a non cash donation between \$500 and \$5,000, the donor needs a contemporaneous written acknowledgement of the gift *and* files Form 8283, Section A.⁵⁰⁷

Contributions over \$250

Any cash or noncash contribution over \$250 must be substantiated by a "contemporaneous" written acknowledgment for the donor to receive her income tax deduction.⁵⁰⁸ In tax parlance, "contemporaneous" means the acknowledgment is made on

⁵⁰⁰ See Hopkins, *Charitable Giving*, §21.2, 781.

⁵⁰¹ Notice 2006-110.

⁵⁰² Notice 2008-16.

⁵⁰³ Prop. Reg. §1.170A-16(a)(1); see Hopkins, *Charitable Giving*, §21.4, 792, §24.7(a), 851-860 (reporting noncash gifts and Form 8283). The charity has a parallel reporting requirement, Form 990, Schedule M. Schedule M (of Form 990) differentiates between works of art, publications, clothing and household goods, vehicles, intellectual property, securities, qualified conservation interests, real estate, jewelry and gems, collectibles, inventory, drugs and medical supplies, taxidermy, historical artifacts, scientific specimens, archaeological artifacts, personal papers and manuscripts, and archival records. *Id.*, §24.7(b), 860-868.

⁵⁰⁴ Reg. §1.170A-13(b)(1); Price, *Estate Planning*, §8.7.1.

⁵⁰⁵ Treas. Reg. §1.170A-13(b)(2)(ii).

⁵⁰⁶ Prop. Reg. §1.170A-16(b); see Hopkins, *Charitable Giving*, §21.4, 792.

⁵⁰⁷ Code §§170(f)(ii)(A), (B); Prop. Reg. §1.170A-16(c)(1); see Hopkins, *Charitable Giving*, §21.4, 792-793 (Form 8283, Section A).

⁵⁰⁸ Code §170(f)(8)(A); Reg. §1.170A-13(f)(1); Prop. Reg. §170A-15(a); see Hopkins, *Charitable Giving*, §21.3, 782. Alternatively, the charity can file a return with the IRS listing the information that would be in a written acknowledgement. For vehicle donations, the substantiation floor is \$500. Logically (since the

or before the earlier of (a) the date the tax return is filed or (B) the return's due date.⁵⁰⁹ This substantiation requirement applies to all charities, including family controlled private foundations.⁵¹⁰

The written acknowledgment should include: (1) the money amount and description of property contributed, (2) a description and good faith estimate of the value of any goods or services (beyond *de minimis* value) received by the donor in consideration (in part or in whole) for the contribution (see quid pro quo rules below), and (3) a statement if the charity provided any intangible religious benefits.⁵¹¹

The charity's "good faith estimate" is the fair market value of goods or services "without regard" to how the organization "made that estimate."⁵¹² The IRS defines "in consideration for" as if, when the donor makes the payment to the charity, the donor receives or expects to receive goods or services in exchange for the payment to the charity.⁵¹³ The IRS defines "intangible religious benefit" as "any intangible religious benefit" (1) "provided by an organization organized exclusively for religious purposes" and (2) "not sold" commercially "outside the donative context."⁵¹⁴

Separate Payments

The \$250 substantiation rule applies to separate payments, which are not aggregated when applying the \$250 floor.⁵¹⁵ For donations from payroll withholdings - a popular

donor is claiming the income tax deduction), the donor has the burden of proof to keep good records and obtain substantiation documentation. *Id.*, §21.3, 784. The donor also carries the burden of proof in appraisal or tax controversy matters. *Id.*, §21.8, 807-808. Indeed, the substantiation rules focus on the donors, not the charity, to report gift information to the IRS. *Id.*, §21.3, 784.

⁵⁰⁹ Code §170(f)(8)(C); Reg. §1.170A-13(f)(3); see Hopkins, *Charitable Giving*, §21.3(a), 783.

⁵¹⁰ Code §170(f)(8); Reg. §1.170A-13(f).

⁵¹¹ Code §170(f)(8)(B); Reg. §1.170A-13(f)(2). The Tax Court strictly reads the acknowledgment requirements. See e.g. *Boone Operations Co., LLC v. IRS*, 105 T.C.M. 1610 (2013); *Durden v. IRS*, 103 T.C.M. 1762 (2012); *Linzy v. IRS*, 102 T.C.M. 482 (2011); *Friedman v. IRS*, 99 T.C.M. 175 (2010); *Kendrix v. IRS*, 91 T.C.M. 666 (2006). See Hopkins, *Charitable Giving*, §21.3(a), 782-783.

⁵¹² Reg. §§1.170A-13(f)(7), -13(f)(5) ("good or services" as money, property, services, benefits, and privileges). Charitable deductions can fail without substantiation. *Cor v. IRS*, T.C. Memo 2013-240. See also *Addis v. IRS*, 118 T.C. 528, *aff'd* 374 F.3d 881 (9th Cir. 2004), *cert. den.*, 543 U.S. 1151 (2005). See Hopkins, *Charitable Giving*, §§21.3(a), (b), 784, 789.

⁵¹³ Reg. §1.170A-13(f)(6); See Hopkins, *Charitable Giving*, §21.3(a), 784. The "in consideration for" rules impact charitable fundraising. See e.g. Hopkins, *The Law of Fundraising and Fundraising Law Made Easy*. But some good or services the charity gives donors in consideration for donations need not be substantiated: (1) de minimis value, where the benefits' fair market value is up to 2% of the lesser of the contribution or \$50 (Reg. §1.170A-13(f)(8)(i)(A)), (2) a contribution of \$25 or more and the consideration given is less than \$5 (Reg. §1.170A-13(f)(8)(i)(A)), (3) annual membership benefits given for donating up to \$75 per year, such as free/discounted admission to the organization and events, free/discounted parking, preferred access to goods/services, and discounts on purchasing goods/services (Reg. §1.170A-13(f)(8)(i)(B)(1)), (4) annual membership benefits given for donating up to \$75 per year, including admission to members only events (Reg. §1.170A-13(f)(8)(i)(B)(2)), and (5) good or services provided to an organization's employees in return for donating up to \$75 per year (Reg. §1.170A-13(f)(9)(i)). See Hopkins, *Charitable Giving*, §21.3(a), 784-786.

⁵¹⁴ Code §170(f)(8)(B) (last sentence); See Hopkins, *Charitable Giving*, §21.3(a), 782-783; see Kirschten, *Charitable Contributions*, A-49 – A-54.

⁵¹⁵ See Hopkins, *Charitable Giving*, §21.3(a), 783.

method of charitable giving often matched by the employer – each paycheck deduction is a separate payment.⁵¹⁶ So each separate \$250 payment requires separate written acknowledgment, but to simplify donor and charity communications, a letter, postcard, email, or computer generated form is acceptable.⁵¹⁷ Indeed, the charity may send a written acknowledgment on a rolling basis, or it may simplify its correspondence by giving donors a periodic or annual acknowledgment.⁵¹⁸ For regular, recurring donations (say an individual tithing to their church or faith community from their wages or monthly or quarterly contributions to a charity, museum, Symphony, or other cultural institution), this timing flexibility allows charities and donors to streamline their correspondence and records.

Contributions over \$500

For property donations over \$500, the donor must keep more records, including (1) a written description of the donated property, (2) how the donor bought the donated property, (3) the date the donor acquired the property, (4) and the cost or basis of the property.⁵¹⁹ If the donor owned the property more than 6 months before her donation, she only needs property basis records if the information is available.⁵²⁰ Noncash contributions over \$500 trigger Form 8283, Section A, which is attached to the donor's tax return. A noncash contribution over \$5,000 triggers (1) appraisal and (2) Form 8283, Section B.⁵²¹ The \$500 floor is calculated by summing all similar property items donated to one charity.⁵²²

Vehicle Donations

If a donor gives a car, truck, boat, or aircraft (a qualified vehicle) valued at over \$500 to a charity, she must receive a Form 1098-C or similar contemporaneous written acknowledgment from the charity and include the written acknowledgement with her tax return. The acknowledgment should: (1) identify the donor, (2) list's the taxpayer's EIN and the vehicle's VIN, (3) include a description and good faith estimate of the value of any goods or services the charity gives the donor in exchange for the vehicle donation. If an intangible religious benefit is given to the donor for the vehicle donation, the written acknowledgement should so state.

If the charity sells the vehicle without (a) significant intervening use or (b) material improvement, the acknowledgment to the donor must (1) certify the vehicle was sold in an arm's length transaction between unrelated parties, (2) list the gross proceeds from the vehicle sale, (3) and state that the donor's deduction cannot exceed the gross proceeds.

⁵¹⁶ *Id.*

⁵¹⁷ See e.g. Notice 2002-25; see Hopkins, *Charitable Giving*, §21.3(a), 783.

⁵¹⁸ See Hopkins, *Charitable Giving*, §21.3(a), 784.

⁵¹⁹ Reg. §1.170A-13(b)(3); Price, *Estate Planning*, §8.7.1. The cost or basis prong does not apply for marketable securities.

⁵²⁰ Reg. §1.170A-13(b)(3)(i); see Kirschten, *Charitable Contributions*, A-30 – A-37, B-101 – B-103 (citing *United States v. American Bar Endowment*, 477 U.S. 105 (1986), and quid pro quo rules).

⁵²¹ Reg. §1.170A-13(c).

⁵²² Code §170(f)(11).

But if the charity keeps the vehicle for (a) significant intervening use or (b) materially improves the vehicle, the acknowledgment to the donor must (1) certify the charity’s use or improvement, (2) the time frame for the charity’s vehicle use, (3) and the vehicle will be kept by the charity during the use or improvement period. The donor can claim the vehicle’s fair market value as a deduction.⁵²³

Quid Pro Quo Contributions

Often a donor makes a contribution to a charity in exchange for goods or services – say purchasing a ticket to a dinner or charity gala where the donor will be served food, have a chance to dance, or bid in a silent auction.⁵²⁴ A *quid pro quo* contribution is a payment “made partly as a contribution and partly in consideration for goods or services provided to the [donor] by the [charity] organization.”⁵²⁵ When the donor makes a quid pro quo contribution over \$75, the charity must provide the donor a written statement about (1) the contribution amount is deductible is limited and (2) a good faith estimate of the value of goods or services.⁵²⁶ But the quid pro quo rules don’t apply to (1) recipients who are state or federal governments or political subdivisions⁵²⁷ or (2) religious charities where the donor only receives an intangible religious benefit not sold commercially outside the donative scenario.⁵²⁸

3. *Appraisal*

The appraisal rules were introduced in 1984, with modifications in 2004 (the American Jobs Creation Act) and 2006 (the Pension Protection Act).⁵²⁹ The appraisal rules focus on a qualified appraisal by a qualified appraiser.⁵³⁰ The documentation rules above apply with the appraisal rules.⁵³¹ The substantiation requirements do not apply to gifts of (1) cash, (2) patents or intellectual property, (3) publicly traded securities on established markets, (4) inventory or property held by the donor for sale to customers in the ordinary course of her trade or business, or (5) a qualified vehicle sold by the charity without significant intervening use or material improvement where the donor is given a written acknowledgment.

⁵²³ Code §170(f)(12); Notice 2005-44; Notice 2006-1.

⁵²⁴ See Hopkins, *Charitable Giving*, §22.2, 814-818; see Kirschten, *Charitable Contributions*, B-1701.

⁵²⁵ Code §6115(b); see Hopkins, *Charitable Giving*, §22.2, 814.

⁵²⁶ Code §6115(a); Reg. §§1.6115-1, 1.6115-1(a)(1) (good faith estimate); see Hopkins, *Charitable Giving*, §22.2, 814; see Kirschten, *Charitable Contributions*, A-199 – A-201.

⁵²⁷ Code §170(c)(1).

⁵²⁸ Code §6115(b).

⁵²⁹ See Hopkins, *Charitable Giving*, §21.5, 795.

⁵³⁰ Code §§170(f)(11)(E)(i) (“qualified appraisal”), 170(f)(11)(E)(ii) (“qualified appraiser”); Reg. §1.170A-13(c); Prop. Reg. §1.170A-17(a)(1); Notice 2006-96; see Hopkins, *Charitable Giving*, §§21.5(a), 21.5(b), 796-799, 799-802; see Kirschten, *Charitable Contributions*, B-201 – B-202; see Price, 8.7. The donor pays for the qualified appraisal on her donation, but she can claim the appraisal cost as a miscellaneous deduction on Schedule A (of Form 1040). Rev. Rul. 67-461.

⁵³¹ A deduction is allowed without appraisal where the appraisal failure arose from reasonable cause, not willful neglect.

Donation over \$5,000

Any donation (other than cash or publicly traded securities) of more than \$5,000 must have a detailed appraisal.⁵³² Donations of over \$5,000 carry three substantiation threads: (1) a contemporaneous written acknowledgment, (2) a qualified appraisal by a qualified appraiser, and (3) Form 8283, Section B.⁵³³ The appraisal requirement applies to individuals, partnerships, or corporations. The IRS requires a “qualified appraisal,” and the donor includes a summary of the appraisal with the donor’s income tax return. The tax filing bar rises for donations over \$500,000, as the qualified appraisal must be attached to the taxpayer’s income tax return.⁵³⁴ The substantial compliance doctrine can provide some relief to a donor.⁵³⁵

Qualified Appraisers Yield Qualified Appraisals

The appraiser conducting the qualified appraisal cannot be connected to the donor or the charity – a neutral, objective third party appraiser must be used. Usually a party (or employee of the party) from whom the donor acquired the property cannot be the appraiser. An appraiser catch-all provision disqualifies any appraiser whose relationship to the various parties would cause a reasonable person to question the appraiser’s independence.⁵³⁶

Form 8283: Appraisal Reporting to the IRS

Form 8283. Beyond getting a qualified appraisal, the donor must also file a Form 8283, signed by the appraiser and the charity, for contributions over \$5,000. The donor must also include Form 8283 with her income tax return when she claims the deduction. If the donor fails to substantiate her contribution, her deduction will not be allowed.⁵³⁷

Donation Threshold Paradigms

To decide if the \$500, \$5,000, or \$50,000 donation thresholds apply, the donor aggregates the values of similar property items.⁵³⁸ If the donor gives several works of art to different charities, she must aggregate the artworks’ values to see if the donation thresholds have been passed.⁵³⁹

Appraisal Summary

An appraisal summary (Form 8283, Section B) must be attached to the donor’s tax return where over \$5,000 is claimed. An appraisal is required for similar items given to one or more charities, such as stamps or coins, with a total value over \$5,000. The appraisal requirements don’t apply to publicly traded securities, including subscription rights, bonds, debentures or other indebtedness evidence where market quotes are available on

⁵³² Code §170(f)(11)(C).

⁵³³ Code §170(f)(11)(c); Prop. Reg. §1.170A-16(d)(1); see Hopkins, *Charitable Giving*, §21.4, 793.

⁵³⁴ Code §§170(f)(11)(D), (E)(i); Regs. §§1.170A-13(c)(3)-(6) (qualified appraisal requirements); Prop. Reg. §1.170A-17(a)(1); see Hopkins, *Charitable Giving*, §§21.4, 793-794, 21.5(a), 796.

⁵³⁵ See Hopkins, *Charitable Giving*, §21.5(c), 802-805.

⁵³⁶ Reg. §1.170A-13(c)(5).

⁵³⁷ See e.g. *Hewitt v. IRS*, 109 T.C. 258 (1997).

⁵³⁸ Code §170(f)(11)(F).

⁵³⁹ Reg. §1.170A-13(c)(7)(iii).

an established securities market.⁵⁴⁰ For non-publicly traded stock (such as in a privately held corporation) valued between \$5,000 and \$10,000, the appraisal requirement is relaxed: no qualified appraisal is needed and part of the appraisal summary can be done.⁵⁴¹

Appraisal Penalties

Penalties can apply to bad appraisals, so donors and appraisers (or even charities) have a strong incentive to ensure accurate appraisals and valuations are done and reported.⁵⁴²

D. Recent Changes and Current IRS Focus/Conclusion

- a. The news and Internet have been awash for several years with the IRS tax exempt scandal. Fortuitously, it appears that the tidal waves of scandal have made landfall, so the IRS can now recalibrate and move forward.⁵⁴³ A leading tax lawyer notes the disarray.⁵⁴⁴
- b. As the IRS recovers from the tax exempt scandal, its outlook is bright with reform on several fronts.⁵⁴⁵
- c. Hybrid entities – a charity owns a business in a subsidiary to avoid losing its tax exempt status from unrelated receipts outweighing charitable activity receipts in the scale of the tax exempt organization calculus.
- d. The IRS also wants to be sure that when charities supporting overseas efforts, those efforts are actually charitable.⁵⁴⁶
- e. The IRS specifies issues each year where it will not rule.

If you have any questions or would like more information about nonprofit or tax exempt issues, please contact Steve for a free consultation, at (913) 707-9220 or steve@johnsonlawkc.com. © 2020, Stephen M. Johnson.⁵⁴⁷

⁵⁴⁰ Reg. §1.170A-13(c)(7)(xi).

⁵⁴¹ Reg. §1.170A-13(c)(2)(ii).

⁵⁴² Code §6695A; see Hopkins, *Charitable Giving*, §21.6, 805-807; see Kirschten et al, *Charitable Contributions: Income Tax Aspects* (Bloomberg BNA, No. 521), A-215 – A-216.

⁵⁴³ “The IRS has suffered mightily over the last two years or so ... Triggered by a mishandling of a relative handful of applications ... the resulting brouhaha nearly destroyed the Exempt Organizations Division ... much of its top management is gone and replaced, and the authority for much of the technical work ... has been delegated to the Office of Chief Counsel. A number of significant initiatives were under way when the debacle began; they are all now languishing. The IRS will rebound from these disasters, but that will take considerable time.” Bruce R. Hopkins, *The Law of Tax Exempt Organizations*, xxxi.

⁵⁴⁴ Hopkins, *Tax Exempt Organizations*, xxxi.

⁵⁴⁵ Hopkins, *Starting and Managing a Nonprofit Organization*, 267-282.

⁵⁴⁶ Politics shapes the Code: Gifts to terrorists or Communists are not deductible. Code §§170(k), 501(p), 508(d), 4948(c)(4); Reg. §§1.170A-1(j)(3), 1.170A-1(j)(2); Hopkins, *Charitable Giving*, §10.11, 517-518.

⁵⁴⁷ This memo is written for informational use only by clients of Johnson Law KC LLC. This memo does not constitute legal, tax, or accounting advice, and should not be relied on for professional advice in your situation. This memo does not establish an attorney client relationship with Johnson Law KC LLC.