

HOW TO OBTAIN AND MAINTAIN TAX-EXEMPT STATUS

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TABLE OF CONTENTS

| | <u>Page</u> |
|---|-------------|
| I. <u>Organizational and Operational Tests</u> | 1 |
| <i>a. Organizational Test</i> | 1 |
| <i>b. Operational Test</i> | 2 |
| II. <u>Private Inurement and Private Benefit</u> | 3 |
| <i>a. Private Inurement</i> | 3 |
| <i>b. Private Benefit</i> | 3 |
| III. <u>Lobbying</u> | 4 |
| IV. <u>Political Activities</u> | 5 |
| V. <u>Unrelated Business Income Tax</u> | 6 |
| VI. <u>Annual Reporting Obligations</u> | 6 |
| VII. <u>Operating in Accordance with an Organization’s Stated Exempt Purpose</u> | 7 |
| VIII. <u>Illegal Activities</u> | 7 |

EXHIBITS

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|---|---|
| A | Rev. Rul. 2007-41 |
| B | Texas Certificate of Amendment |
| C | Delaware Certificate of Amendment for Non-Stock |
| D | IRS PLR 202217009 |

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Each year, the IRS revokes the tax-exempt status of organizations exempt from taxation under §501(c)(3) of the Internal Revenue Code of 1986 (the “Code”). Tax-exempt status is frequently revoked automatically due to failure to file informational returns, such as the 990-N, 990-EZ, and the 990, and occasionally, exempt status is revoked following an audit. This paper provides an outline of the major initial and ongoing requirements for tax-exempt organizations and common reasons organizations lose their tax-exempt status.

I. Organizational and Operational Tests

To qualify under §501(c)(3) as an exempt organization, an organization must be organized and operated exclusively for a specific exempt purpose. Such exempt purposes include:

- religious,
- charitable,
- scientific,
- testing for public safety,
- literary, or educational purposes,
- to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or
- for the prevention of cruelty to children or animals.¹

The organizational test relates to the organization’s governing documents and operational test related to the ongoing operations of the organization.

a. Organizational Test

Only certain types of entities may qualify as tax-exempt under §501(c)(3). Corporations, community chests, funds or foundations are valid organizational forms. In addition, a limited liability company may even qualify as tax-exempt if it meets the following requirements:

(1) both the LLC's articles of incorporation and its operating agreement each include (i) provisions requiring that each member of the LLC be either (i) an organization described in section 501(c)(3) and exempt from taxation under section 501(a) or (ii) a governmental unit described in section 170(c)(1) (or wholly-owned instrumentality of such a governmental unit), (ii) express charitable purposes and charitable dissolution provisions in compliance with §1.501(c)(3)-1(b)(1) and (4), (iii) the express chapter 42 compliance provisions described in section 508(e)(1), if the LLC is a private foundation, and (iv) an acceptable contingency plan (such as suspension of its membership rights until a member regains recognition of its section 501(c)(3) status) in the event that one or more members cease to be section 501(c)(3) organizations or governmental units (or wholly-owned instrumentalities thereof; and

¹ IRC § 501(c)(3).

- (2) The LLC must represent that all provisions in its articles of incorporation and operating agreement are consistent with applicable state LLC law and are legally enforceable; and
- (3) all other general requirements under §501(c)(3) are met.²

An organization's articles of incorporation must also limit the purposes of such organization to a valid exempt purpose and must provide that all assets will be dedicated to an exempt purpose upon dissolution.³ The articles of incorporation must also not empower the organization to engage, otherwise than as an insubstantial part of its activities, in activities which in themselves are not in furtherance of one or more exempt purposes.⁴

b. Operational Test

An organization will meet the operational test only if it engages primarily in activities which accomplish one or more of such exempt purposes specified in section 501(c)(3). An organization will not meet the operational test if more than an insubstantial part of its activities is not in furtherance of an exempt purpose(s).⁵ In addition, an organization will also not meet the operational test if its net earnings inure in whole or in part to the benefit of private shareholders or individuals, or such organization is an "action organization."⁶ An organization is an "action organization" if:

- (1) a substantial part of its activities is attempting to influence legislation by propaganda or otherwise;
- (2) it participates or intervenes, directly or indirectly, in any political campaign on behalf of or in opposition to any candidate for public office; or
- (3) it has the following two characteristics:
 - (a) Its main or primary objective or objectives (as distinguished from its incidental or secondary objectives) may be attained only by legislation or a defeat of proposed legislation; and
 - (b) it advocates, or campaigns for, the attainment of such main or primary objective or objectives as distinguished from engaging in nonpartisan analysis, study, or research and making the results thereof available to the public.⁷

Exempt organizations should therefore ensure that it can demonstrate that its primary activities are in furtherance of its exempt purpose(s). If certain activities are not clearly in furtherance of its exempt purposes, the organization should analyze whether they constitute insubstantial activities and determine whether to continue those activities. While there is no bright line test for whether or not an activity is "insubstantial," courts have looked at the percentage of gross income derived

² Department of the Treasury, Internal Revenue Service, Notice 2021-56.

³ Treasury Regulation § 1.501(c)(3)-1(b)(1) and (b)(4).

⁴ Treasury Regulation § 1.501(c)(3)-1(b)(1).

⁵ Treasury Regulation § 1.501(c)(3)-1(c)(1).

⁶ Treasury Regulation § 1.501(c)(3)-1(c)(2) and (c)(3).

⁷ Treasury Regulation § 1.501(c)(3)-1(c)(2)(ii) – (iv).

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