

THRESHOLD ISSUES IN FORMING OR ADVISING
A NEW YORK NOT-FOR-PROFIT ORGANIZATION

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Pamela A. Mann is the principal in the Law Offices of Pamela A. Mann, LLC, a practice concentrated in the representation of tax exempt organizations. Drawing on its comprehensive expertise in issues facing such organizations, the office is counsel to numerous public charities and private foundations and advises its clients in a wide range of governance, regulatory, tax, and general corporate matters. From 1985 to 1995, Ms. Mann was Chief of the Charities Bureau in the New York Attorney General's office, directing scores of important cases and initiatives and influencing the adoption of significant legislative changes affecting tax exempt organizations. Ms. Mann was Chair of the Committee on Nonprofit Organizations of the Association of the Bar of the City of New York from 1998-2001 and has served as President and Vice-President of the National Association of State Charities Officials. She is a member of the Government Relations Committee of the Nonprofit Coordinating Committee of New York and of the Exempt Organizations Committee of the American Bar Association. She has written many articles for professional and lay publications and is a frequent lecturer on non-profit issues. She is a graduate of Oberlin College and the University of Pittsburgh School of Law.

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I Threshold Questions

The interrelationship of state, local (i.e., municipal or county), federal, and international laws is a primary source of complexity in the representation of not-for-profit organizations.

- A. Given the organization's planned activities and sources of support, what form of (federal) tax exemption should it seek?
- B. What form should the not-for-profit organization take and, if in corporate form, in what state should it incorporate?
- C. Does the organization's planned activities or structure raise issues under particular bodies of law, including laws of local jurisdictions or other countries than the United States?

¹ The conceptual framework and portions of the analysis contained in this article are based on presentations on the same topic made in years past by David A. Shevlin of Simpson, Thacher & Bartlett. The author acknowledges his inspiration with gratitude.

II. Selected Terms

Even the nomenclature used in this area of the law reflects the multi-jurisdictional approach required.

- A. "Tax-Exempt Organization" and "Exempt Organization" are federal income tax terms. They refer to charitable and non-charitable organizations that are generally exempt from federal income tax.
- B. "Not-for-Profit" or "Nonprofit" are state law terms that refer to an organization organized under the applicable state law as a corporation, trust, or unincorporated association for purposes other than distributing income and profits to private individuals or entities. These entities generally occupy the same territory as those defined in A above.
- C. "Non-Governmental Organization" or "NGO" is a term that describes organization, usually operating outside the United States, that would qualify as a Tax-Exempt Organization if it were organized and operated in the United States.
- D. "Private Foundation" and "Public Charity." The Internal Revenue Service ("IRS") classifies every charitable exempt organization as either a "Private Foundation" or a "Public Charity." Unless an organization can demonstrate a basis for its classification as a "Public Charity," the IRS will classify it as a

"Private Foundation." This classification has enormous significance for an organization's operations, as discussed below. The terms "foundation" and "charity" are often used colloquially to refer to organizations that have not been categorized as Private Foundations or Public Charities by the IRS. This generally does not raise any legal issues, but sometimes causes confusion.

III. What form of tax exemption should the organization seek?

A. IRC § 501 contains 25 categories of exempt organization; each category describes an organization that carries out other than commercial purposes that benefit the public. Only one of these, Section 501(c)(3), describes an organization that carries out charitable purposes. IRS Publication 557, "Tax-Exempt Status for your Organization," attached to these materials, outlines the characteristics of each category of exemption.

1. If the organization will bring together individuals engaged in a particular trade or business to exchange ideas, work on projects of common concern, etc., it will likely be categorized as exempt under Section 501(c)(6).

2. If the organization will devote itself to social or recreational purposes, it will likely be categorized as exempt under Section 501(c)(7).

3. If the organization will promote charitable or educational purposes and intends to engage in substantial lobbying activities, it may be categorized as exempt under Section 501(c)(4).

B. 501(c)(3) organizations are entitled to unique benefits not available to organizations in the other 24 exempt categories. Because they receive special benefits, they are subject to significant limitations on their activities.

1. Gifts to 501(c)(3) organizations, alone among the 25 categories of exemption, are deductible by the donor pursuant to IRC § 170.

2. 501(c)(3) organizations must be organized and operated exclusively for religious, charitable, educational, literary, or scientific purposes; for testing for public safety; prevention of cruelty to children or animals; or fostering amateur sports competitions.

3. The significant limitations on the activities of 501(c)(3) organizations include:

a. No part of the organization's net earnings can be distributed to an individual ("private inurement")

b. Politicking is prohibited, and only limited lobbying is allowed.

4. Only contributions to U.S. 501(c)(3) organizations are deductible; U.S. organizations may make contributions outside the U.S., but only under certain conditions.

C. Section 501(c)(3) organizations are further divided into two types pursuant to IRC § 509(a): public charities and private foundations. Private foundations are treated less favorably under the Code.

1. Private Foundations

a. An organization that anticipates funding from one source or from related individuals and/or entities, intends to make grants rather than engage in programs, and anticipates revenue from its investments rather than from donations or program activities generally will be categorized as a private foundation.

b. Limits on the deductibility of contributions to private foundations are generally lower than for gifts to public charities.

c. Private foundations are generally subject to the rather onerous provisions of Chapter 42 of the Code,

including a tax on net investment income (IRC § 4940), a minimum distribution requirement (IRC § 4942), severe taxation of certain expenditures (IRC § 4945), which effectively prohibit lobbying by private foundations, and prohibition on "self-dealing," discussed below. Thus, where feasible, nonprofit organizations will seek public charity status.

d. An organization that intends to carry out charitable programs but cannot, or does not wish to, meet the criteria of a public charity, may be categorized as a "Private Operating Foundation."

e. One species of private foundation, the family foundation, presents particular types of governance and operational issues. Generally, a family foundation is one created in memory of a family member or entire family, where all members of the board of directors are related.

2. Public charities

a. "Traditional" charities, such as churches, schools and colleges, hospitals, as well as governmental units, are considered to be public charities by virtue of their activities alone. IRC §§ 509(a)(1) and 170(b)(1)(A)(i)-(v).

b. "Publicly supported" organizations. Those organizations that do not fall within the categories enumerated above may be characterized as public charities by virtue of their receiving financial support from the general public, either from contributions or program revenues.

1) To qualify, these organizations must have a sufficiently large number of donors making donations of relatively similar size to satisfy one of two "public support tests": a mechanical test or a "facts and circumstances" test.

2) Alternatively these organizations must receive fees for their services as their primary method of support.

3) These organizations must be accountable to the public, rather than to a single donor or family, as reflected in their activities, their board composition, and their general focus.

3. Supporting organizations

a. Organizations that are organized and operated exclusively for the benefit of, to perform the functions of, or to carry out the purposes of one or more traditional charities or publicly supported organizations described immediately above

will be classified as public charities rather than private foundations.

b. Supporting organizations must be operated, supervised, or controlled by or in connection with the supported organizations, and may not be controlled by certain "disqualified persons." IRC § 509(a)(3).

D. Key Issues for Determining the Appropriate Tax Status

1. Is deductibility essential for donations to the organization? If so, it will have to seek a 501(c)(3) designation.

2. Will the organization carry on fundraising activities that will allow it to satisfy the public support test? Alternatively, will its programs regularly generate fees as a main source of income? If so, it should seek public charity status.

3. Will the organization have one major donor or set of related donors? If so, does the donor want significant control over the philanthropic direction of the organization? As discussed above, a 501(c)(3) with one major donor or set of related donors will likely be categorized as a private foundation. If the donor is not particularly interested in maintaining maximum control

over the organization, it may be appropriate to consider forming a supporting organization or a donor- advised fund under the auspices of a community foundation or similar entity, as an alternative to forming a private foundation.

4. Does the organization plan to devote substantial amounts of time or resources to lobbying? If so, it should not seek an exemption under 501(c)(3), as they may only engage in limited amounts of lobbying activities.

IV. Given the planned activities and tax classification to be sought, should the entity incorporate and, if so, under which law (and which state's laws) should it incorporate?

A. Generally, nonprofit organizations incorporate as not-for-profit or nonstock corporations, although they may also be formed as trusts or as unincorporated associations. In New York, churches must incorporate under the New York Religious Corporation Law, and museums, schools, and historical societies generally incorporate under the Education Law.

1. If the organization incorporates in a state other than the state in which it plans to operate, it should take into account the laws of both the state of incorporation and the state of operation in devising its governing structure.

Many organizations that operate in New York incorporate in Delaware and obtain authority to do business in New York.

2. In the course of preparing the organization's governing documents, fundamental issues of governance, e.g., whether the organization will have voting members, board structure and rules of operations, etc., must be addressed in light of relevant state and federal laws.

B. State tax exemptions. Organizations should also apply for exemptions available to them under state and local laws. Exemptions from state franchise tax, sales tax, and real estate taxes are typically available.

V. Operational Issues under State and Federal Laws

A. Maintaining the federal tax exemption. Because exemption is a privilege, the IRC imposes ongoing obligations on organizations that are exempt from federal taxation under Section 501. See generally, "Stay Exempt," <http://www.stayexempt.org>, a website produced by the IRS summarizing these obligations for 501(c)(3) organizations.

1. They must file yearly informational tax returns (Form 990, 990EZ or 990PF). IRC § 6033. Certain types of organizations, e.g., churches, are exempt from this requirement.

IRC § 6033(a)(2)(A).

2. All exempt organizations must make available for public inspection and copying their exemption applications and their annual information returns for the past three years.
IRC § 6104(d)

3. Prohibition on political campaign activity and limitation on lobbying for 501(c)(3) organizations.

a. 501(c)(3) organizations that engage in any political campaign activity (electioneering) are subject to revocation of their exempt status.

b. “No substantial part” of a charity’s activities may consist of lobbying, although IRC § 501(h) provides a safe harbor that allows an electing public charity to make expenditures for lobbying within calculable dollar amounts.

c. Section 4945 effectively prohibits private foundations from expending funds for lobbying activities by imposing excise taxes on such expenditures.

4. Unrelated Business Income Tax. Exempt organizations should be aware that income from other than exempt purpose activities is subject to tax under IRC § § 512-

514. Excessive unrelated business income will jeopardize an organization's exempt status. See IRS Publication 598, "Tax on Unrelated Business Income of Exempt Organizations."

- B. Fundraising. The laws of some 37 states require organizations that raise funds from the public in those states to register prior to commencing solicitations. In New York, Article 7A of the Executive Law sets out registration and reporting requirements for charities that raise funds from the public in this state. In New York, as in most other jurisdictions with such laws, fundraising professionals must also register and, often, file bonds and contracts prior to solicitation.
- C. Investment and Management of Funds. State laws (and, with respect to private foundations, IRC provisions imposing excise taxes on "jeopardizing investments") set standards for the conduct of not-for-profit organizations in the area of management of restricted and unrestricted funds and investment of such funds. Many states, including New York, have enacted the Uniform Management of Institutional Funds Act. See N-PCL § § 512, 514, 522. Cf. the Prudent Investor Act, applicable to trustees, including trustees of charitable trusts. EPTL § 11-2.3.

VII. Beyond the Threshold. The full scope of issues on which not-for-profit organizations may require legal advice

is extremely broad. It ranges from business issues they may have in common with non-exempt organizations – such as employment issues, contracts with other entities or individuals, and intellectual property issues – to issues that are particular to exempt organizations beyond those mentioned above. For example, organizations that make fundamental changes in their activities or corporate structure will be subject to particular provisions of state law; private foundations must be mindful of the regulatory regimen governing grant-making; organizations operating outside of the United States must follow certain practices to maintain “discretion and control” over funds expended internationally.