

# BACK TO BASICS: EXEMPTION FUNDAMENTALS

Fizer Beck

## Introduction.

### ► Why seek federal tax exemption?

- Income exempt from federal income tax (other than UBTI).
- Income also may be exempt from certain state taxes.
  - See Tex. Tax Code §151.310 (sales tax), §171.063 (franchise tax), §11.18 (property/ad valorem).
- Contributions (from individuals and corporations) are tax deductible.
- Preferred postal rates and ability to issue tax-exempt bonds.

### ► Trade-Offs?

- Operating and reporting requirements.
- Additional disclosure obligations.
- Federal and state oversight.

# Choice of Entity (State Law).

- ▶ **Nonprofit Corporation:** Formed pursuant to certificate of formation (must file with Secretary of State (SOS)); Governed by Texas Business Organizations Code (TBOC); Flexible structure with greater certainty of how rules apply.
- ▶ **Charitable Trust:** Formed pursuant to trust agreement (not filed with SOS); Governed by Texas Trust Code; Difficult to alter Grantor's original goals.
- ▶ **Unincorporated Association:** Often formed pursuant to governing document of some kind (not filed with SOS); Governed by TBOC; Three or more members joined by mutual consent for a common, nonprofit purpose; Increased liability concerns with this structure.
- ▶ **Single-Member LLC:** Useful form of entity for subsidiary of tax-exempt organization; Formed pursuant to certificate of formation (must file with SOS); Sole member of the SMLLC must be tax-exempt; Governed by TBOC; LLC is flexible structure, but case law less developed than corporation case law.

## 501(c)(3) Overview.

- ▶ “Corporations, and any community chest, fund or foundation, **organized** and **operated** exclusively for religious, charitable, scientific, testing for public safety, literary or educational **purposes**, or 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, **no part of** the net earnings of which inures to the benefit of any private shareholder or individual, **no substantial part of** the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation, (except as otherwise provided in subsection (h)), **and which does not participate in, or intervene in** (including the publishing or distributing of statements), any political campaign on behalf of (or in opposition to) any candidate for public office.” (emphasis added)
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| Organizational Test                     |
| Operational Test                        |
| Exempt Purpose                          |
| Private Inurement & Private Benefit     |
| Lobbying                                |
| Political Campaigns                     |
| Public Policy ( <u>Bob Jones Case</u> ) |

# The Organizational Test.

- ▶ **To satisfy the Organizational Test**, the “articles of organization” of the organization must:
  - (1) State that organization's purpose is limited to one or more exempt purposes;
  - (2) Not expressly authorize engagement in activities that do not further such purpose(s), unless such engagement is only to an insubstantial degree; and
  - (3) State that, upon its dissolution, the organization's assets shall remain exclusively dedicated to one or more exempt purposes.
  - (\*) Additional provisions for private foundations (PF excise taxes). [§508(e)]
- ▶ **“Articles of Organization”** refers to certificate of formation for nonprofit corporations, trust agreement for charitable trusts, or the respective governing document pursuant to which the entity is formed.

# The Operational Test.

- ▶ **To satisfy the Operational Test**, organization must engage primarily in activities that further the exempt purpose(s) of the organization.
- ▶ **“Insubstantial” Activity Okay.** Organization may still engage in activity that does not further its exempt purpose(s), if such activity is only an “insubstantial” part of overall activities (Note “Private Benefit Test”).
- ▶ **“In Furtherance of” Inquiry.** IRS generally looks to the purpose that the at-issue activity is primarily designed to accomplish, not to its outward form or conventionally understood purpose (*i.e.*, depends on facts and circumstances).

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First appeared as part of the conference materials for the  
2019 Nonprofit Organizations Back to Basics Workshop session  
"1A: Back to Basics: Exemption Fundamentals"