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Tax-Exemption Applications – Why They Still Matter

There is an old saying about the troublingly broad power of prosecutors to secure criminal indictments: they “could get a grand jury to indict a ham sandwich.” With the decline in the IRS’s budget, particularly for overseeing exempt organizations, I occasionally wonder whether someone could get the IRS to issue that same ham sandwich a 501(c)(3) determination letter. After all, if the ham sandwich is expecting less than \$50,000 per year in revenue and otherwise qualifies for -EZ filing, it just needs to check the right boxes on the **Form 1023-EZ** and the IRS letter will likely follow.

As tempting as it is to be cynical, I believe that is the wrong way to think about tax-exemption applications. For several reasons, we still strongly recommend that new organizations be thoughtful about their tax-exemption application and where helpful, hire a lawyer with nonprofit expertise to help them craft and submit it.

For one, it is very possible to do it wrong. Nearly every week, the IRS releases another batch of 501(c)(3) denial letters. Examples from the first few weeks of this year so far include:

- An **adult softball league** that did not realize 501(c)(3) status is generally for *youth* sports, not *adult* sports.
- An **organization focused on medical marijuana** whose founders did not realize the federal ban on marijuana effectively prevented it from qualifying as a 501(c)(3).
- A **relief fund for members of a union** that did not realize it needed a broader charitable class to qualify.
- An **organization that sounded like a 501(c)(6) trade association** that did not realize what changes it could have made to qualify it as a 501(c)(3) organization.

If you rush through the tax-exemption application, you could spend months waiting for a determination letter, only for the IRS to ultimately say “No.” If you take your time and get advice where needed, you can often hammer out any issues and structure activities to obtain the tax status sought while still accomplishing your goals.

Counterpoint: Tens of thousands of organizations file Form 1023s and Form 1023-EZs each year and just a handful (relatively speaking) of them are denied.

True. BUT, getting a determination letter may not be worth much if the application doesn’t fully and accurately explain the organization’s charitable activities.

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Nonprofit Law Matters looks at legal issues in the nonprofit and tax-exempt organizations world. Written by the attorneys and paralegals of Adler & Colvin, it provides updates and analysis regarding philanthropy, charity, and other exempt organization issues.

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Generally speaking, an organization (and in limited situations, its donors) cannot rely on a determination letter if the organization made material misrepresentations (including omissions) in its tax-exemption application. (Anecdotally, organizations operating without expert assistance frequently, if inadvertently, make misrepresentations under penalty of perjury in the Form 1023 or Form 1023-EZ).

On the other hand, a well-crafted tax-exemption application provides significant protection to your exempt status for novel or potentially misinterpreted activities, at least if they're properly designed and implemented in practice, and fully and accurately described in the application. And, if you generate income from an activity that, in the IRS's view, is insufficiently related to charitable purposes, your organization may still owe tax on that income under the unrelated business income tax regime.

If you and/or your donors cannot rely on your 501(c)(3) determination letter and you may have to pay taxes anyway, what have you accomplished by rushing through the application?

Counterpoint: Okay, but isn't that all theoretical? Practically speaking, once the IRS recognizes an organization as exempt, deductible contributions can be made to that organization, which would be listed in Publication 78 (accessible through GuideStar) and the IRS website. And the organization will file Form 990s like any other charity and generally only pay tax on unrelated business income, instead of filing corporate tax returns and paying tax on all of its income.

Perhaps that's true in most cases. But that brings us to the most important point, which is that a nonprofit's success or failure goes far beyond whether it receives an IRS determination letter.

If your organization is using funds in a manner inconsistent with 501(c)(3) purposes, your state Attorney General can get involved regardless of whether the IRS approved it. In California, for example, the Attorney General has extremely broad enforcement powers, including the power to hold directors personally liable for misspent funds. And, even if the state Attorney General does not get involved, the organization's reputation with donors and the public will likely catch up with it eventually, undermining its chances of success.

This is a long way of saying: With the right provisions in the governing documents, you might be able to get a ham sandwich a determination letter, but that does not make it a functioning charity that will survive and that donors will support in the long term. It will just be a sandwich with a piece of paper.

For organizations aspiring to more than that, going through the process of doing a full tax-exemption application backed by knowledgeable advice can provide additional protection and put the organization on a path to full compliance with applicable law and best practices.