

Do Something (Right)! How to Pass the Section 501(c)(3) Operational Test

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Sometimes doing nothing is better than doing something, like not stepping on a landmine. But usually taking some level of action in the right direction is far more preferable, especially when the IRS examines a nonprofit organization's activities for whether it has been operated as legally required. Both operating for improper purposes and not operating at all may be fatal to a nonprofit's Section 501(c)(3) qualification.

Operation: Exempt Purpose

By definition, a Section 501(c)(3) organization – whether a public charity or a private foundation - must be organized *and operated* exclusively for tax-exempt purposes as listed in this Internal Revenue Code provision. Applicable tax law imposes a two-part test: “Organizational” and “Operational.” The organizational test focuses on the organization's charter paperwork, such as the express purposes set forth in its articles of incorporation (e.g., “exclusively for charitable, religious, and educational” purposes). The operational test requires the organization to engage exclusively, interpreted as being “primarily,” in activities that accomplish one or more of these Section 501(c)(3) exempt purposes. The presence of a single non-exempt purpose, if substantial, precludes exempt status regardless of the number or importance of truly exempt purposes.

Thus, even if a nonprofit is organized for valid Section 501(c)(3) purposes, its activities must primarily further those exempt purposes in order to qualify or retain such status. In other words, if an organization is organized for charitable purposes, like running a soup kitchen, it also needs to be operated mostly as a soup kitchen. If an organization is organized for religious or educational purposes, like a church or a school, it likewise needs to be operated as a church or school.

Sounds pretty basic, right? But the test can quickly get problematic, like when an organization engages in business activities to raise funds. Such activities need to be relatively insubstantial – that is, ancillary to the nonprofit's tax-exempt purposes. An organization may not primarily advance individuals' private interests, rather it must operate for the *public* benefit. And the nonprofit must actually operate, not lie dormant for years at a time.

When Doing Something was the Wrong Thing

The IRS applies the operational test by examining the nature and character of nonprofits' activities, such as when an organization applies for tax-exempt recognition or in connection with its IRS Form 990 annual filing. For example, the IRS recently revoked an organization's

tax-exempt status after finding that it was primarily operated for commercial real estate rental activity, which is not a Section 501(c)(3) tax-exempt purpose. The IRS's conclusion was based on the organization's own program information in its Form 990, which lacked any description about nonprofit services or charitable funding. (See www.irs.gov/pub/irs-wd/201710035.pdf.)

A more complicated example of doing the wrong thing is *Capital Gymnastics Booster Club, Inc. v. Comm'r* (T.C. Memo 2013–193). In that case, the nonprofit operated as a booster club for families of gymnasts, who were all on teams from a private gym. The families individually paid fees to the gym. They additionally could offset fees owed through various fundraising activities, with profits credited to them individually.

Upon examination of the club's Form 990, the IRS determined although its stated purpose was tax-exempt (to operate an amateur athletic association), it operated to significantly promote private interests – namely the gymnasts' families who personally received the financial benefits from organizational fundraising. The club's actual activities undertaken thus *in fact* furthered a non-exempt purpose, despite the organization's claims to the contrary. The IRS therefore revoked the club's tax-exempt status retroactively for failing the operational test.

When Doing Nothing Was the Wrong Thing

Another operational test problem area is when an organization lacks any activity, not just the wrong activity. How could this come up, as a practical matter? In *Cnty. Educ. Found. v. Comm'r*, T.C. Memo 2016–223, the nonprofit first learned that its Section 501(c)(3) tax-exempt status had been revoked for failure to file its Form 990, as is automatic for a three-year consecutive failure to file. The organization then sought retroactive reinstatement through the requisite IRS Form 1023 application for recognition of tax-exempt status.

Upon review of the Form 1023 application, the IRS recognized that the organization originally had been properly organized for exempt charitable and educational purposes. However, the nonprofit had lain dormant from 2001 through its 2008 date of automatic revocation. On appeal to the U.S. Tax Court, the Court held that the nonprofit failed the operational test “because it did not engage in any activity that accomplished one or more of the exempt purposes in section 501(c)(3).” In other words, doing nothing amounts to a serious problem for government approval of tax-exempt qualification.

Lessons Learned

Understandably, many exempt organizations may have periods of dormancy or inactivity for a variety of reasons endemic to the nonprofit world. Funding issues are common and frequently disrupt a nonprofit organization's ability to operate on any level until it is able to recover a steady flow of donations or funding from other sources. Circumstances surrounding changes in governance, from transitioning boards of directors to changes in the

bylaws, may hinder the efficiency and ability of an organization to operate in furtherance of an exempt purpose. And maturing understandings of an organization's mission (and exempt purposes) and its evolving plans and strategies to further its exempt goals can result in periods of inactivity, in order to conserve resources for subsequent undertakings.

So should a nonprofit with periodic spans of dormancy be worried about their tax-exempt status? Hopefully not. As a key compliance tool, the nonprofit's leaders should be sure to file its IRS Form 990 information return. If the organization is doing very little, then the simple Form 990-N may be filed online. The Form 990-N requires only minimal information to be reported: the organization's name, EIN, and verification that it has received less than \$50,000 for the applicable tax year.

The nonprofit's leaders should additionally consider and memorialize any actual activity, such as occasional fundraising letters, leadership meetings, or other efforts to keep the organization going. And if the nonprofit is long dormant, it may be best to just dissolve it as a corporation. The leadership can later start fresh with an entirely new organization, with new focus, energy, and capability to satisfy the Section 501(c)(3) operational test.

For nonprofits that actively maintain programs and services, their leaders need to stay continually mindful of the operational test. Ask the important questions. For example, does the nonprofit primarily engage in tax-exempt activities, consistent with its expressly stated charitable, religious, or educational purposes? Are its fundraising (or other non-exempt) activities getting so large as to possibly eclipse such tax-exempt purposes? Are any individuals or businesses privately benefitting from some of the nonprofit's activities? Is further due diligence, accountant assistance, or legal counsel needed to address these matters further? And how should the nonprofit report its program activity and financials on its Form 990, to best demonstrate that it fully satisfies the operational test? Asking these questions along the way, rather than waiting for the IRS to possibly do so, reflects prudent and wise nonprofit leadership.



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