

## FREQUENTLY ASKED QUESTIONS ABOUT NONPROFIT CORPORATIONS AND 501(C)(3) STATUS

*This publication is for general information only and cannot substitute for legal advice. Different organizations will have different needs and problems resulting in different legal consequences. Every issue discussed is complex, so always consult an attorney for advice on specific situations.*

### 1. What does it mean for a community group to organize itself as a nonprofit corporation?

Becoming a corporation allows a group to be treated as an entity in and of itself, rather than simply as a collection of individuals. For example, a corporation can own property and enter into contracts in its own name, and members/directors/officers may be protected against personal liability for the acts and debts of the corporation.

In Kentucky, nonprofit corporations are formed by filing “Articles of Incorporation” containing legally required information with the Kentucky Secretary of State. The one-page “Articles of Incorporation” form on the KY Secretary of State website is not sufficient for groups aspiring to 501(c)(3) status, as the Internal Revenue Service requires additional provisions.

### 2. What does it mean to be a *nonprofit* corporation?

A nonprofit corporation is one in which the income and profits go back into the corporation to further its nonprofit purposes instead of being distributed to its members, officers or directors. In contrast, a for-profit corporation exists to make money for its owners and shareholders.

### **3. Who owns a nonprofit corporation?**

By law, no individual – not even a founder – owns or controls a nonprofit corporation. The affairs of a nonprofit corporation are managed by a board of directors acting as a group and following the organization’s bylaws, which must comply with the KY Nonprofit Corporations Acts.

### **4. What are some of the pros and cons of becoming a nonprofit corporation?**

In addition to allowing an organization to be treated as an entity in and of itself, rather than as a collection of individuals, the corporate form provides some protection to individual members and directors from liability for the organization’s conduct and debts. On the other hand, incorporation decreases the flexibility a group has in running its affairs; once incorporated, it must follow Kentucky law regarding nonprofit corporate governance and decision-making. It will also have to comply with state reporting requirements and state and federal tax laws and may incur some financial costs – in addition to time and paperwork – to maintain the group’s corporate status.

### **5. What does it mean to be a 501(c)(3) organization?**

A 501(c)(3) organization is a particular kind of nonprofit. “501(c)(3)” refers to a section of the U.S. Internal Revenue Code that allows organizations meeting conditions in the law to enjoy certain tax benefits. Only organizations that are organized and operated exclusively for religious, charitable, scientific, literary or educational purposes, or to do testing for public safety, foster amateur sports competition or prevent cruelty to children or animals may qualify. Further, to qualify an organization (1) may not be organized or operated for the benefit of private interests; (2) may not allow its earnings to inure to any private shareholder or individual; (3) may not attempt to influence legislation as a substantial part of its activities; and (4) may not participate in any campaign activity for or against political candidates.

### **6. What are the main benefits of 501(c)(3) status?**

A 501(c)(3) organization is exempt from paying federal income tax on most types of income. In Kentucky, 501(c)(3) organizations are also exempt from state income tax and most Louisville Metro net profits taxes, and may apply to be exempt from sales and property taxes. Further, donations made to a 501(c)(3) organization are tax deductible, meaning that

individuals who itemize and businesses that donate money or goods can take a deduction to the extent permitted by law when they file their income tax returns. In addition, government entities, foundations and businesses often require the organizations they support to have 501(c)(3) status.

## **7. What are the main drawbacks of 501(c)(3) status?**

Because of the tax advantages they enjoy, 501(c)(3) organizations are highly regulated. Members of the board of directors must learn about and comply with the many legal requirements that apply to 501(c)(3) organizations. The IRS requires 501(c)(3) organizations to keep detailed records showing proper expenditures and operations and legal compliance with IRS rules, and (except for churches and some church-affiliated organizations) to file annual information returns.<sup>1w</sup> Which form to file and how complex the return will be depends upon the organization's annual gross receipts and total assets.

There are also strict prohibitions against insiders improperly benefitting from their relationship with the organization, and severe financial penalties for the organization and the individual when these rules are violated.

## **8. Can 501(c)(3) organizations lobby?**

Yes. The tax law allows 501(c)(3) organizations to "attempt to influence legislation" as long as those efforts are not a "substantial" part of their activities. The term "legislation" includes acts, bills, laws or similar items of a legislative body such as Congress, the General Assembly, Metro Council or Fiscal Court, as well as referendums, ballot initiatives or constitutional amendments to be voted upon by the public. Attempts to "influence legislation" include both "direct" lobbying (meaning communication with a legislator that expresses a view about specific legislation) and "grassroots" lobbying, where the organization expresses a view about specific legislation to the general public with a call to action.

## **9. How can a 501(c)(3) organization make sure it's lobbying activities will not be considered a "substantial" part of its activities?**

Exceeding the limits on lobbying may result in the IRS imposing an excise tax on an organization and/or revoking its tax-exempt status. The simplest way to make sure that its lobbying activity will be considered *insubstantial* is for an organization to elect to have its

lobbying measured under the “expenditure test.” It can then use a formula in the law to calculate how much it can spend on lobbying and remain “insubstantial.” To elect to use the expenditure test, an organization files a simple half-page form with the IRS, Form 5768.

## **10. Is there a tax-exempt status that allows nonprofit community organizations to do unlimited lobbying?**

Yes. Tax exempt status under section 501(c)(4) is available to what the Internal Revenue Code calls “social welfare” organizations or “civic leagues.” Unlike 501(c)(3)s, 501(c)(4) organizations can do as much lobbying as they wish, as long as these activities fall within the organization’s exempt purposes. However, contributions made to 501(c)(4) organizations are not tax deductible.

In addition to the freedom to lobby, 501(c)(4) organizations may also engage in political campaign activities to a limited extent, as long as this is not the organization’s primary activity. However, they must file a special tax return if they do so, and pay a tax based upon the amount spent on campaign activities.

As is the case for 501(c)(3)s, there are strict prohibitions on individual directors or members profiting from their relationship with a 501(c)(4) organization, and severe financial penalties for the organization and the individual when these rules are violated. Section 501(c)(4) organizations, too, must file an annual information return with the IRS. Again, which form must be filed and how complex the return will be will depend upon the organization’s annual gross receipts and total assets.

## **11. How does a nonprofit corporation become recognized as a 501(c)(3) or 501(c)(4) organization?**

By filing an application for recognition of tax-exempt status with the IRS, using the appropriate on-line form. The type, length and complexity of the application, as well as the filing fee, will depend upon the organization’s particular circumstances. As of January 1, 2022, filing fees are either \$275 or \$600. Churches, some church-affiliated organizations and some organizations that do not normally have annual gross receipts over \$5,000 may enjoy 501(c)(3) status without filing an application, provided they otherwise qualify as a 501(c)(3).

In addition, any nonprofit that intends to operate as a 501(c)(4) organization must so notify the IRS within 60 (sixty) days of its formation. This is done electronically, by filing an on-line form and paying a \$50.00 fee. Failure to do so results in a penalty of \$20/day for each day the failure continues, up to a maximum of \$5,000. This notification requirement applies regardless of whether the organization plans to apply to the IRS for recognition of 501(c)(4) status.

*Legal Aid Society's **Community Development Legal Assistance Program** assists eligible community-based nonprofit organizations working on issues of concern to low income people and communities in Louisville and Breckenridge, Bullitt, Grayson, Hardin, Henry, Larue, Marion, Meade, Nelson, Oldham, Spencer, Shelby, Trimble and Washington Counties. For more information, visit us on the web at <https://yourlegalaid.org/nonprofit-resources>.*

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