

Prepare Your Tax Exemption Application

Now it's time to fill in your tax-exemption application. First check to see if you qualify to use the 1023-EZ application by completing the Form 1023-EZ Eligibility Worksheet. The Eligibility Worksheet can be found at the end of IRS Instructions for Form 1023-EZ (available on the IRS website and in Appendix C). If you qualify to use the 1023-EZ application, you will need to go to the IRS website and complete the form online. If you don't qualify, you'll have to use the longer 1023 application and should go on to our second set of instructions for Form 1023, below.

Instructions for Form 1023-EZ

Below are instructions to help you complete the Form 1023-EZ application, which is available on the IRS website and must be completed online. Many of the questions are self-explanatory and easy to answer. We provide a few pointers to help you understand what the IRS is looking for. For some items, we point you to instructions that we provide for the longer Form 1023. For additional guidance, look at the official IRS instructions to Form 1023-EZ, available on the IRS website and in Appendix C.

Part I: Identification of Applicant

Check the box at the top of the form to confirm that you completed the 1023-EZ Eligibility Worksheet and are eligible to file the 1023-EZ.

Line 1(a)–(e). Write the name of your corporation exactly as it appears in your articles of incorporation. Provide the mailing address of the corporation. If you do not have a street address, provide a post office box address. The

IRS wants you to include the full nine-digit zip code in your address. Include it if you know it. (Zip code information can be obtained online at the U.S. Postal Service Zip Code lookup page.)

Line 2. You'll need an EIN for your nonprofit corporation. See Form 1023 instructions, below, Part I, Item 4, for information on how to get one.

Line 3. Insert the month your corporation's tax year ends. Use a two-digit month number for your response. See Form 1023 Instructions, below, Part I, Line 5, for more information.

Lines 4–6. State the name of a director or officer the IRS can contact regarding your application, the phone number where this person can be contacted during business hours, and a fax number. The fax number is optional—if you don't want to provide one, insert “not applicable.”

Line 7. Insert “\$275,” which is the user fee that you pay if you qualify to use Form 1023-EZ.

Line 8. List the names, titles, and mailing addresses of your officers, directors, or trustees. Only list five. If you have more than five, select the ones to be listed as explained in the official instructions to Form 1023-EZ. Most smaller nonprofits have a president (or CEO), treasurer (or CFO), secretary, and perhaps a vice president and/or chairman of the board. If a person serves in more than one capacity, only list the person once and show the title of all positions held by that person. You can use the address of the corporation as the mailing address of your directors and officers.

Line 9. If applicable, list the website address of your nonprofit, and its email address. Any website content should be consistent with your nonprofit purposes and program as described in your 1023 application. Insert “N/A” if either item is not applicable.

Part II: Organizational Structure

Line 1. Check the corporation box.

Line 2. Check this box to indicate that you have the required organizing document; namely, articles of incorporation that have been certified as having been filed with the state.

Line 3. Insert the date your articles were filed by the secretary of state in mm/dd/yyyy format.

Line 4. Insert your state of incorporation.

Lines 5–7. If you followed our instructions in Chapter 6 for preparing your articles, you should be able to check each of these three boxes to indicate that your articles of incorporation contain the required provisions with respect to 501(c)(3) purposes, limitation of activities, and dedication of assets.

Part III: Your Specific Activities

In this section, the IRS wants to get an idea of how your nonprofit will actually operate. In some cases, your response may result in follow-up questions from the IRS (for example, if you indicate that you will pay officers or directors or engage in legislative activity, the IRS may want to make sure that the compensation is reasonable or the political activities insubstantial before granting your exemption). It's best to be as honest as you can at the start, and dispose of any issues the IRS raises early on, to avoid any potential problems later. Before filling in this section, read the official 1023-EZ instructions for each of the questions in this section; these instructions provide or point you to more information on some of the issues, activities, and purposes listed in this section.

Line 1: Provide a brief description of your primary tax-exempt activities or goals. Try not to repeat verbatim the purpose clause language in your articles (Chapter 6). A summary or gloss of the purpose clause language from your bylaws (Chapter 7) may be used here if it describes your most important activities or mission.

Line 2. The list of 3-character NTEE Codes is included in the official 1023-EZ instructions. Select the one that best matches your 501(c)(3) purposes and/or activities.

Line 3. Check the box(es) that match(es) the 501(c)(3) purpose(s) contained in your articles (see instructions in Chapter 6 to preparing Article 3, “Federal 501(c)(3) Tax-Exempt Purpose Clause”).

Line 4. You should be able to check this box to show that you will abide by these 501(c)(3) operational requirements (see Chapter 3, “Other Requirements for 501(c)(3) Groups,” for more information on these requirements).

Line 5. If you will attempt to influence legislation, check the “Yes” box. For the 501(c)(3) limits on this activity, and to consider whether you should make an election using Form 5768, see Chapter 3, “Limitation on Political Activities.”

Line 6. If you will pay your officers or directors (or think you will), check the “Yes” box. We’ve already explained the basic 501(c)(3) prohibition against private inurement and the excess benefit rules that penalize nonprofits and their managers if they pay unreasonable compensation to insiders and outsiders (see the discussion on the excess benefit rules in “Limitation on Profits and Benefits,” in Chapter 3).

Lines 7–12. If you check “Yes” to any responses, the IRS may ask for additional details in follow-up questions to ensure that your nonprofit is operating within allowable 501(c)(3) limits. These are: no private inurement or special benefits to individuals (including directors and officers); only incidental—not substantial—unrelated business income; no support to restricted foreign entities; and no bingo or gaming activities. Here are some pointers for more information on some special issues associated with these items:

- **Unrelated Business Income.** If you anticipate that your organization will earn \$1,000 or more in annual unrelated business income,

the IRS may send you additional questions to determine, based on the description you provide of your proposed operations, that such business income will not be a primary activity of your nonprofit (see Chapter 3, “Unrelated Business Activities”). Also be prepared to file annual 990-T forms as explained in “Federal Corporate Tax Returns” in Chapter 10).

- **Bingo and gaming.** See IRS Publication 3079, *Tax-Exempt Organizations and Gaming*.
- **Foreign operations.** Special tax exemption and deductibility of contribution rules apply to nonprofits created or operated abroad. If you plan to operate or provide assistance abroad, you may wish to seek guidance from a nonprofit adviser who has experience in advising nonprofits that operate in the foreign countries where you plan to operate. Also see “Foreign Organizations in General” in the official standard Form 1023 instructions for basic information on nonprofits formed abroad. Finally, realize that a big part of the IRS’s energies is now devoted to scrutinizing the operations of foreign-based nonprofits as part of the service’s participation in antiterrorism. Here is an excerpt from the IRS 2005 EO (Exempt Organization) report:
In FY 2005, EO will examine a sample of foreign grant making organizations; the primary focus of the examinations is to ensure that funds are used for their intended charitable purpose and not diverted for terrorist activity. The project will gather information about current practices, that is, the existence and effectiveness of controls put in place to monitor the distribution of overseas grants and other assistance. This committee will also address the need for possible guidance or other modifications to the laws in this area.

- **Disaster Relief.** The IRS may prioritize the processing of your application if your organization provides disaster relief. For more information, see IRS Publication 3833, *Disaster Relief: Providing Assistance Through Charitable Organizations*.

Part IV: Foundation Classification

This is a technical section, which seeks to determine whether your 501(c)(3) will be a public charity or a private foundation. To help you answer the questions in this section, reread Chapter 4, where we explain the importance of qualifying your 501(c)(3) tax-exempt organization as a public charity and explain the three basic ways your organization can qualify as a public charity. Also read the official 1023-EZ instructions for this section.

Line 1: Certain nonprofits that may qualify for public charity status (we call this category “Automatic Public Charity Status” in Chapter 4), including churches, schools, and hospitals, do not qualify to use Form 1023-EZ. These nonprofits have to check “Yes” for this question and must use Form 1023 to apply for their tax exemption and public charity status. Therefore, Form 1023-EZ and the remaining questions in this section of the 1023-EZ only apply to groups that can check “No” for this question and can seek to qualify as a public charity because of the types of public support or exempt purpose revenue they receive (they qualify as a public charity under either the “Public Support Test” or the “Exempt Activities Support Test” as described in Chapter 4).

Line 2. Check one of the boxes in this section to tell the IRS how you plan to qualify as a public charity. You can use the 1023-EZ instructions to calculate whether you meet either of these two tests:

- (a) Check this box if you calculate that you should qualify as a public charity under the “Public Support” test covered in Chapter 4.
- (b) Check this box if you calculate that you should qualify as a public charity under the “Exempt Activities Test” test covered in Chapter 4.
- (c) Certain organizations operated for the benefit of a governmental college or university (e.g., state school) qualify as public charities. We assume you are not forming this special type of nonprofit, but if you are, see a nonprofit specialist with experience with this sort of organization for guidance in forming your nonprofit and obtaining your tax-exemption and qualifying as a public charity.

Line 3. We assume readers will check box 2(a) or (b) to seek public charity status for their 501(c)(3) tax-exempt organization. If you do not calculate that you should qualify to check either the 2(a) or (b) box, and end up prepared to check box 3, you should get the help of a nonprofit adviser to form a private foundation and obtain its 501(c)(3) tax exemption (see Chapter 4, “Private Foundations” for more information).

Part V: Reinstatement After Automatic Revocation

You can ignore this section. It is used by nonprofits that have already obtained and lost their 501(c)(3) exemption due to a failure to file their annual IRS Form 990 informational tax returns. (Read the official 1023-EZ instructions to this section for more information). It’s good to know that Form 1023-EZ can be used for this purpose, but by staying on top of your ongoing nonprofit tax filing responsibilities after you obtain your tax exemption (see Chapter 10), you will never need to do so.

Submit 1023-EZ Online

You fill in, submit, and pay the filing fee for Form 1023-EZ online. Follow the instructions on the IRS website to submit the form and pay the user fee.

Instructions for Form 1023

Below are the instructions to help you answer the questions on the Form 1023 tax exemption application. If you do not qualify to use the 1023-EZ online application as explained in the previous section, you will need to apply for your tax exemption by completing the longer 1023 application. You can use either the interactive, accessible, or printed version as described at the beginning of this chapter. The official IRS instructions along with our instructions, below, should help you perform this task.

Part I: Identification of Applicant

Line 1: Write the name of your corporation exactly as it appears in your articles of incorporation.

Line 2: If you have designated one person in your organization to receive return mail from the IRS regarding your 1023 application, such as one of the founders, list this person’s name as the “c/o name.” Otherwise, insert “not applicable.”

Line 3: Provide the mailing address of the corporation. If you do not have a street address, provide a post office box address. The IRS wants you to include the full nine-digit zip code in your address. Include it if you know it. (Zip code information can be obtained online at the U.S. Postal Service zip code lookup page.)

Line 4: All nonprofit corporations (whether or not they have employees) must obtain a federal Employer Identification Number (EIN) prior to applying for 501(c)(3) tax exemption. You will insert this number here on your 1023 form and use this identification number on all your future nonprofit federal information, income, and

employee tax returns. Even if your organization held an EIN prior to incorporation, you must obtain a new one for the nonprofit corporate entity. If your nonprofit corporation has not yet obtained an EIN, it should do so now.

Preliminary Interactive Form 1023 Questions

If you use the 1023 interactive form, you are asked preliminary questions before accessing the form online. Here is guidance to help you through these “gatekeeping” questions:

1. Does your nonprofit have an EIN? See Part 1, Line 4, below. If you click “No,” you will be brought to the IRS website page that shows you how to apply for an EIN.
2. Do you have an organizing document? See Part II, Line 1 instructions, below. You should click “Yes” if you have prepared and filed Articles of Incorporation (see Chapter 6).
3. Does your organizing document (Articles) contain the required 501(c)(3) purpose and dissolution clauses. See Part III, Lines 1 and 2, below. If you have prepared your Articles according to the instructions in Chapter 6, you should be able to answer “Yes.”
4. Will you authorize someone to represent your organization or obtain copies of documents on your behalf? See Part I, Line 7. Most readers using this book to set up their own nonprofit and apply for its tax exemption will answer “No.”
5. Will you authorize someone to inspect or receive copies of documents on your behalf? We assume new nonprofits doing their own work will answer “No,” but if you are an existing nonprofit and checked “Yes” to #4, above, because you are using a lawyer or other representative and you will need that person to obtain tax records on your behalf of the IRS, check “Yes,” to download and prepare IRS Form 8821.

The easiest and quickest (and IRS-preferred) way to get an EIN is to apply online from the IRS website. Go to www.irs.gov and type “EIN” in the upper search box. Then click “Go” to open a page that lists links to EIN-related webpages. You should see a link to the online EIN application. You can file this version of IRS Form SS-4, *Application for Employer Identification Number*, online. Fill in and submit the application to receive your EIN immediately.

Follow the instructions, below, when completing the SS-4 form:

- **Name and SSN of officer.** You will need to specify the name and Social Security number of one of your principal officers. Normally the chief financial officer or treasurer will provide a name and SSN here.
- **Type of entity.** Check “church or church-controlled organization” if you are forming one; if not, check “other nonprofit organization” and specify its 501(c)(3) purpose (educational, charitable, and so on).
- **GEN number.** Most groups will ignore this item—it applies only to a group exemption application request. Members of an affiliated group of nonprofits can specify a previously assigned Group Exemption Number.
- **Reason for applying.** Check “started new business,” then specify “formed nonprofit corporation” in the blank. If you are converting an existing unincorporated association (that has previously filed any appropriate tax returns for its association tax years with the IRS) to a nonprofit corporation, you can check “changed type of organization” instead, then insert “incorporation” in the blank.
- **Date Business Started.** The date you started your business is the date your articles were filed with the state filing office. Use the file-stamped date on the copy of your articles returned by the state office.

- **Employees.** You can enter zeros in the next item that asks the number of employees you expect to have in the next 12 months.

Make sure to write down your EIN immediately before changing webpages—you will not be able to back up and retrieve the EIN after you navigate away from the webpage. Print a copy of the online form (you can do this by clicking the “Print Form” button on the IRS webpage after receiving your EIN), write the assigned EIN in the upper-right space of the printed form, then date and sign it, and place the copy in your corporate records.

You also can apply for an EIN by phone. To do this, fill in the SS-4 form (available on the IRS website, or included on the Nolo website—see Appendix A for the link). Then call the IRS at 800-829-4933—be sure to complete the form before making the phone call. If you apply by phone, you will be assigned an EIN immediately. Write this number in the upper right-hand box of a printed SS-4 form, then date and sign it, and keep a copy for your records. The IRS telephone representative may ask you to mail or fax a copy of your signed SS-4 form to the IRS.

You also can apply for an EIN by fax and get your EIN faxed back to you within four business days. See the instructions to Form SS-4 for more information on using the IRS Fax-TIN program.

Finally, you can get an EIN the slow way by simply mailing your SS-4 form to the IRS. Have an officer—typically the CFO or treasurer—sign the form, stating his or her title. Expect to wait at least four weeks. Remember, you can’t complete line 4 of your 1023 form until you have your EIN.

Line 5: Specify the month your accounting period will end. Use a two-digit number for your response. For example, if your accounting period

will end December 31, insert “12.” The accounting period must be the same as your corporation’s tax year. Most nonprofits use a calendar year as their accounting period and tax year. If you choose to do the same, specify “12” here.

If you anticipate special seasonal cycles for your activities or noncalendar year record keeping or grant accountability procedures, you may wish to select a noncalendar accounting period for your corporation. For example, a federally funded school may wish to specify June (“06”) in this blank, which reflects an accounting period of July 1 to June 30.

If you have any questions regarding the best accounting period and tax year for your group, check with your (probable) funding sources and consult your accountant or bookkeeper for further guidance.

Lines 6(a)–6(c): State the name of a director or an officer the IRS can contact regarding your application, the phone number where this person can be contacted during business hours, and a fax number. The fax number is optional—if you don’t want to provide one, insert “not applicable.” We suggest you list the name and telephone number of the director or officer who is preparing and will sign your tax exemption application (see Part XI, below). Nevertheless, don’t expect the IRS to call to ask questions. If the IRS has questions about your application, it will usually contact you by mail.

Line 7: We assume you are filling in your 1023 form yourself, and will mark “no” to this item. However, if you are being helped by a lawyer, an accountant, or another professional representative, mark “yes” to allow the representative to talk on your behalf with the IRS about your 1023 application. If you mark “yes,” you will need to complete and attach an IRS Form 2848, *Power of Attorney and Declaration of Representative* (available from the IRS website), to your 1023 application.

Line 8: We assume most readers will answer “no” here. However, if you have paid or plan to pay an outside lawyer, accountant, or other professional or consultant to help you set up your nonprofit or advise you about its tax status, and the person is not acting as your formal representative (named in Form 2848, as explained in line 7, above) and the person is not a director, an officer, or an employee of your nonprofit, answer “yes” and provide the requested information. Traditionally, many nonprofits get professional guidance from unpaid lawyers and accountants who serve as volunteers to their board. If this is your situation, you can answer “no,” since this item is asking about paid advice from an outsider. There is nothing wrong in paying an outsider for help. The purpose of this question is to require full disclosure of any paid relationships between your nonprofit and its advisers, to make sure the compensation arrangement is fair to the nonprofit, and to see that there is no obvious conflict of interest between the person’s role and his or her paid status. An overriding concern of the IRS is to make sure that one person is not personally directing the organization and operation of your nonprofit to further personal financial interests and agendas.

Many professionals are being more careful these days and will shy away from providing professional advice on nonprofit boards unless they are indemnified and covered by directors’ liability insurance. Some paid advisers will automatically say “no” when asked to sit on a nonprofit board because they do not want to confuse their role as adviser to the nonprofit entity (their real client to whom they owe a professional duty) with the separate task of acting as an adviser to the board and its individual members.

Lines 9(a) and 9(b): Insert the URL for your nonprofit’s website, if you have one. Any website content should be consistent with your

nonprofit purposes and program as described in your 1023 application. Also, provide an email address to receive educational information from the IRS in the future. The email address is optional. If you can’t provide either of these items, insert “not applicable” in the blank.

Line 10: Some nonprofits using this box will be eligible for an exemption from filing IRS Form 990, the annual information return for nonprofits, or the shorter 990-EZ form for smaller groups—see “Federal Corporate Tax Returns” in Chapter 10. If you are reasonably sure you will be exempt—for example, if you are forming a church or know that you will have gross receipts of \$50,000 or less per year—mark “yes” and state the reason why you are exempt on an attachment page. All other nonprofits using this book should mark “no” here. Remember, even if your nonprofit has \$50,000 or less in gross receipts, it must file Form 990-N (e-Postcard) each year. Call IRS Customer Account Services at 877-829-5500 (a toll-free number) and ask that the organization be set up to allow filing of Form 990-N.

We think it is wise to file 990 returns each year, even if you and the IRS initially agree that your group should be exempt from filing the returns. Why? Because you may fail to continue to meet the requirements for the exemption from filing, and may get hit with late-filing penalties if you have to go back and file your returns for prior years that you missed. By filing a return, even if not required, you normally start the running of the time frame during which the IRS can go back and audit your nonprofit tax returns. And your filed 990 can come in handy in many states for meeting your state income tax and any state attorney general filing requirements. Groups exempt from the 990 filing requirements may still have to file a Form 990-N postcard or make the 990-N filing online from the IRS website. See Chapter 10 for the federal tax filing requirements.

Line 11: Insert the date your articles were filed by the secretary of state in mm/dd/yyyy format, such as 01/05/2014.

Line 12: We assume you will mark “no.” If you are seeking an IRS 501(c)(3) tax exemption for a corporation formed abroad, mark “yes,” insert the name of the country, and seek additional help from an adviser who can assist you through your more complicated tax exemption application process.

Part II: Organizational Structure

Line 1: Most tax-exempt nonprofits are formed as nonprofit corporate entities, and we expect you to follow the standard practice of forming a corporation too. Check “yes” to indicate that your group is a corporation and attach a copy of your articles to your application. The copy should be a certified copy you received from the state filing office. It should show a file-date stamp on the first page or include a certification statement or page that states it was filed with the state and is a correct copy of the original filed document.

Line 2: We assume you will check “no” to indicate that you are not seeking a tax exemption for an LLC. Very few nonprofits are formed as limited liability companies. If this is what you are attempting to do, you should consult with an experienced lawyer.

Line 3: We assume you will check “no” here because we expect readers to form a traditional nonprofit tax-exempt corporation, not an unincorporated association. An unincorporated association requires special paperwork (association charter or articles and association operating agreement), and it leaves the members potentially personally liable for the debts of and claims made against the association. If you are applying for a tax exemption for an unincorporated association, you should check with a lawyer before applying for your tax exemption.

Lines 4(a) and 4(b): Check “no” to show that you are not applying for a tax exemption for a nonprofit trust. If you are interested in establishing a tax-exempt trust, see an expert.

Line 5: Check “yes” and attach a copy of the bylaws you have prepared as part of Chapter 7. Make sure you have filled in all the blanks in your printed bylaws and include a completed Adoption of Bylaws page at the end of your bylaws. The adoption page should show the date of adoption and include the signatures of your initial directors.

Part III: Required Provisions in Your Organizing Document

Line 1: Your articles must contain a 501(c)(3) tax-exempt purpose clause (see “Federal 501(c)(3) Tax-Exempt Purpose Clause” in “Complete Your Articles” in Chapter 6). Check the box, and on the line provided insert the page, article, and paragraph where the 501(c)(3) purpose clause appears. Make sure you reference the 501(c)(3) purpose clause, not any state-required lawful purpose or specific purpose clause also included in your articles. For example, the following articles contain both a 501(c)(3) tax-exempt purpose clause and a state-required specific purpose clause:

Article 3. The purposes for which this corporation is organized are:

This corporation is organized and operated exclusively for educational purposes within the meaning of 501(c)(3) of the Internal Revenue Code.

The specific purposes for which this corporation is organized are to educate the general public in dance and other art forms. The means of providing such education includes, but is not limited to, maintaining facilities for instruction and public performances of dance and other art forms.

The group would check the box in line 1, and then, in the space provided at the end of the text in line 1, insert “page 1, Article 3,

paragraph 1”—because the 501(c)(3) tax-exempt purpose clause appears in the first paragraph of Article 3 on page one of the articles.

This group specified only one 501(c)(3) purpose—educational—in its 501(c)(3) exempt-purpose clause. You can choose to use a more general statement that specifies one or more or all of the allowable 501(c)(3) exempt purposes (see “Sample Completed Articles” in Chapter 6).

Line 2: Check the 2(a) box to indicate that your articles contain a 501(c)(3) asset dedication clause (we assume your articles will contain a dedication clause as explained below), and fill in the blank in 2(b) to state the page, article, and paragraph where the dissolution clause appears in your articles. Leave the box in 2(c) unchecked—it applies to groups whose articles do not contain a dissolution clause and are instead relying on specific state law provision as explained below.

A requirement for 501(c)(3) tax-exempt status is that any assets of a nonprofit that remain after the entity dissolves be distributed to another 501(c)(3) tax-exempt nonprofit—or to a federal, state, or local government for a public purpose (see “Limitation on Profits and Benefits” in Chapter 3, and “Additional Federal Tax Exemption Language” in “Complete Your Articles” in Chapter 6). You can meet this irrevocable dedication of assets requirement by including an explicit dedication clause in your articles of incorporation or by relying on state law, if you live in a state that has adopted a 501(c)(3) default dedication clause. Some states have laws requiring all 501(c)(3)s formed in the state to dedicate their remaining assets upon dissolution to another 501(c)(3). We believe that, even if you live in a state that has a default dedication provision, you should always include an explicit dedication clause in your articles. It’s best to state any major restrictions on assets and operations explicitly in your articles as a cautionary reminder to your directors, officers, members, and others. And you won’t have to

research your state law to find out if you have an applicable default provision, or be at risk of your state law changing or the IRS deciding that your state’s dissolution clause is not sufficient to meet the 501(c)(3) dedication of assets requirement.

For example, assume a nonprofit has the following asset dedication clause on page 3 of its articles:

Article 8. Additional Provisions

The property of this corporation is irrevocably dedicated to [state one or more of your actual tax-exempt purposes, such as “charitable,” “religious,” “educational,” “literary,” and/or “scientific”] purposes and no part of the net income or assets of this corporation shall inure to the benefit of any director, officer, or member thereof or to the benefit of any private person. Upon the dissolution or winding up of the corporation, its assets remaining after payment, or provision for payment, of all debts and liabilities of this corporation shall be distributed to a nonprofit fund, foundation, or corporation that is organized and operated exclusively for [repeat the same purpose or purposes stated in the first blank] purposes and that has established its tax-exempt status under Section 501(c)(3) of the Internal Revenue Code.

No substantial part of the activities of this corporation shall consist of carrying on propaganda, or otherwise attempting to influence legislation (except as otherwise provided by Section 501(h) of the Internal Revenue Code), and this corporation shall not participate in, or intervene in (including the publishing or distribution of statements), any political campaign on behalf of, or in opposition to, any candidate for public office.

No part of the net earnings of this corporation shall inure to the benefit of, or be distributable to, its members, directors, officers, or other private persons, except that this corporation shall be authorized and empowered to pay reasonable compensation for services rendered and to make

payments and distributions in furtherance of the purposes set forth in these articles.

Notwithstanding any other provision of these articles, this corporation shall not carry on any other activities not permitted to be carried on (1) by a corporation exempt from federal income tax under Section 501(c)(3) of the Internal Revenue Code or (2) by a corporation contributions to which are deductible under Section 170(c)(2) of the Internal Revenue Code.

This nonprofit would check the box in 2(a), and insert the following on the line in 2(b): “page 3, Article 8, first paragraph.” This article provision (which is taken from “Complete Your Articles,” in Chapter 6, Article 8 instructions) contains additional optional 501(c)(3) compliance language that we recommend all groups include in their articles (see “Optional 501(c)(3) Tax Exemption Language” under “Complete Your Articles” in Chapter 6).

Do not check the 2(c) box. To be thorough, you can insert “Not Applicable” on the line at the end of line 2(c).

The boxes that appear in line 2 will not apply to most incorporators and should be ignored by most groups.

Part IV: Narrative Description of Your Activities

You should be familiar with the material in Chapter 3 concerning the basic requirements for obtaining a 501(c)(3) tax exemption before providing the information requested in this part of the form. We will refer to earlier explanations as we go along, but you may want to look over Chapter 3 now before you proceed.



TIP

Tell it like it is. When you describe your proposed activities, don’t limit your narrative to only those activities that fit neatly within the 501(c)(3) framework if you’re simply “gilding the lily” to

gain IRS approval. Sure, you’ll probably get your tax exemption, but you may not keep it. The IRS can always decide later, after examining your actual sources of support, that your activities go beyond the scope of the activities disclosed in your application. In short, it’s a lot more painful and expensive to shut down your nonprofit if it loses its tax exemption than to decide at the outset not to apply for 501(c)(3) status because your proposed mission does not qualify for tax-exempt status.

On an attachment page, provide a detailed description of all of your organization’s activities—past, present, and future—in their order of importance (that is, in order of the amount of time and resources devoted to each activity). For each activity, explain in detail:

- the activity itself, how it furthers an exempt purpose(s) of your organization, and the percentage of time your group will devote to it
- when it was begun (or, if it hasn’t yet begun, when it will begin)
- where and by whom it will be conducted, and
- how it will be funded (the financial information or projections you provide later in your application should be consistent with the funding methods or mechanisms you mention here). For example, if your application shows you will be obtaining the bulk of your tax-exempt revenue from providing program-related services, such as tuition or admission fees, and/or from grant funds, you will want to mention these sources of support here (see additional instructions on describing your financial support below).

Many new groups will be describing proposed activities that are not yet operational, but you must still provide very thorough information.

If you plan to conduct any unrelated business (business that doesn’t directly further your nonprofit goals), describe it here. Most nonprofits

will not have planned unrelated business activities at this point. If you have, you will not want to stress the importance or scope of these incidental unrelated activities (for an explanation of the tricky issues surrounding unrelated business activities, see Chapter 3).

Tempting though it might be, resist copying the language that already appears in the purpose clause in your articles—the IRS wants a narrative, not an abbreviated, legal description of your proposed activities. You may include a reference to, or repeat the language of, the longer statement of specific objectives and purposes included in Article 2, Section 2, of your bylaws. However, unless your bylaw language includes a detailed narrative of both your activities and purposes, we suggest you use it only as a starting point for a fuller response here. Generally, we recommend starting over with a fresh, straightforward statement of your group's nonprofit activities.

EXAMPLE 1: A response by an environmental organization might read in part as follows:

The organization's activities will consist primarily of educating the public on environmental issues with an emphasis on energy conservation. Since January 20__, the organization has published brochures promoting solar energy heating systems as an alternative to traditional energy sources. The price for the brochures is slightly above cost—see copies of educational material enclosed, Attachments A–D. The brochures are published in-house at [address of principal office]. Both paid and volunteer staff contribute to the research, writing, editing, and production process. This work constitutes approximately 80% of the group's activities. In addition to publishing, the organization's other activities include the following [list in order of importance other current, past, or planned activities and percentage of time devoted to each, where performed, etc.].

EXAMPLE 2: A nonprofit organization plans to sponsor activities for the purpose of supporting other nonprofit charities. It should describe both the activities in which it will engage to obtain revenue at special events and the manner in which this money will be spent to support other groups. Percentages of time and resources devoted to each should be given.

If you are forming an organization that automatically qualifies for public charity status (a church, school, hospital, or medical research organization) or has special tax exemption requirements, you will want to show that your organization meets the criteria that apply to your type of organization. See “Automatic Public Charity Status,” in Chapter 4, for a discussion of each of these special types of nonprofits. In the 1023 form, you'll find schedules and instructions that apply to each type of special group (for example, Schedule A for churches, Schedule B for schools, and Schedule C for hospitals). If you are forming one of these special types of nonprofits, skip ahead to “Filling Out the Schedules” and look over the instructions for the schedule you need to complete. That way, you'll have a better understanding of what the IRS is looking for in your statement about your nonprofit activities.

Your description should indicate your organization's anticipated sources of financial support—preferably in the order of magnitude (most money to least money). Here are a few tips to help you address this portion of your response:

- Your sources of support should be related to your exempt purposes—particularly if you plan to be classified as a public charity under the support test described in “Exempt Activities Support Test,” in Chapter 4, where the group's primary support is derived from the performance of tax-exempt activities.

- If you plan to qualify as a publicly supported public charity (described in “Public Support Test,” in Chapter 4), your responses here should show significant support from various governmental grants, private agency funding, or individual contributions.
- If you expect your principal sources of support to fluctuate substantially, attach a statement describing and explaining anticipated changes—see the specific instructions to Part II, line 2, in the 1023 package.

Your description should show how you will fund your activities. For example, if you will give classes, state how you will recruit instructors and attract students. If you will rely on grants, state your likely sources of grant support—for example, the particular or general categories of grant agencies you plan to approach. If your nonprofit expects to obtain funds through grant solicitations or other fundraising efforts—that is, by soliciting contributions from donors either directly or through paid fundraising—make sure you provide a narrative description of these efforts here, and also refer to Part VIII, line 4, of your application, where you will provide additional information on your fundraising activities (see instructions to Part VIII, below).

Include as exhibits any literature you plan to distribute to solicit support and indicate that this material is attached to your application.

Fundraising activities include unrelated business activities that will bring cash into your nonprofit. If you have concrete plans to engage in unrelated activities (which, of course, you should be able to clearly describe as an insubstantial part of your overall activities), include the details if you have not done so already in your response.

If your organization has or plans to have a website, provide information on the existing site (including its URL) or the planned site. The existing or proposed website content and any revenue it generates should be related to and further the exempt purposes of the group. If your website is used to solicit contributions or generate other revenue, explain how this is or will be done.

Finally, if your group intends to operate under a fictitious business name (an “aka”—also known as—or “dba”—doing business as—name) that differs from your formal corporate name as stated in your articles (see “File Fictitious or Assumed Business Name Statement” in Chapter 9), make sure to mention the alternate name here, and state why you want to use an alternate name.

Part V: Compensation and Financial Arrangements With Your Officers, Directors, Trustees, Employees, and Independent Contractors

The IRS has expanded this part of the application to try and prevent people from creating and operating nonprofits simply to benefit one or more of the nonprofit’s founders, insiders, or major contributors. We’ve already explained the basic 501(c)(3) prohibition against private inurement and the excess benefit rules that penalize nonprofits and their managers if they pay unreasonable compensation to insiders and outsiders (see “Limitation on Profits and Benefits” in Chapter 3). In this part of the application, the IRS tries to find out if your nonprofit runs the risk of violating any of these rules. So if you have compensation or other financial arrangements with any of your founders, directors, officers, employees, contractors, contributors, and others, now is the time to disclose this information. It’s better to find out ahead of time that the IRS objects

to your proposed financial arrangements rather than pay hefty excess benefit taxes later and run the risk of losing your tax exemption.

Line 1(a): Provide the names, titles, mailing addresses, and proposed compensation of the initial directors named in your articles and your initial officers. You can ignore the instructions concerning trustees—your directors are the trustees of your nonprofit corporation. List your initial directors and your top-tier officer team, if you know who will fill these officer positions (such as president or chief executive officer, vice president, secretary, and treasurer or chief financial officer, or any other title used in your organization). For director or officer mailing addresses, you can state the mailing address of the corporation.

At this stage in the organization of your nonprofit, you may not be absolutely certain what you will pay your initial directors and officers. However, if you have a good ballpark estimate or a maximum amount in mind, it's better to state it in your response instead of "unknown" or "not yet decided." In the sample bylaws included in this book, we say that directors will not be paid a salary but may be paid a per-meeting fee and reimbursed expenses (see Article 3, Section 6). Therefore, you may wish to respond along the following lines:

"Pursuant to Article 3, Section 6, of the corporation's bylaws, directors will not be paid a salary. They may be paid a reasonable fee for attending meetings of the board [you may mention a specific amount or a range if you have decided on a per diem fee] and may be allowed reasonable reimbursement or advancement for expenses incurred in the performance of their duties." This response will not fit in the "Compensation amount" column, so you'll need to prepare your response as an attachment if you use this wording.

If you have decided on officers' salaries or a range or maximum compensation level for officers, you can state it in your response. If you are not sure who your board will appoint as initial officers and do not know the compensation level for your officers, you may wish to respond as follows: "The persons who will serve as officers and the compensation they will receive, if any, have not yet been determined by the board of directors. Any such compensation will be reasonable and will be paid in return for the performance of services related to the tax-exempt purposes of the corporation." This response will not easily fit in the space provided for your 1(a) response, so you'll probably need to prepare your response as an attachment if you use this wording.

If you have decided who will be elected to serve as officers, provide the details of these officer arrangements, including the amount of any salaries to be paid.

Line 1(b): In this section, state the names, titles, mailing addresses, and compensation for your five top-paid employees who will earn more than \$50,000 per year. You should include employer contributions made to employee benefit plans, 401(k)s, IRAs, expected bonus payments, and the like in computing the amount of compensation paid to your employees. You should list only employees who are not officers (all officer salaries should be reported in line 1(a) of this Part). It's best to anticipate who will be paid more than \$50,000 by providing estimated compensation figures rather than leaving this information blank. However, if you really don't know yet which officers you will pay or how much you will pay them, you can respond as follows: "This corporation is newly formed and has not yet hired employees nor determined the amount of compensation to pay employees it may hire."

However, all compensation will be reasonable and will be paid to employees in return for furthering the exempt purposes of this nonprofit corporation.”

There is nothing special or suspect about paying an employee more than \$50,000. In fact, compensation paid to employees who make less than \$80,000 (a figure that is adjusted for cost of living increases) normally is not subject to scrutiny under the excess benefit rules. (See “Limitation on Profits and Benefits,” in Chapter 3, for more on the excess benefit rules.) If you are interested in the \$80,000 category and how it fits within the excess benefit rules, see IRS Regulation 53.4985-3(d)(3)(i) and IRC Section 414(q)(1)(B)(i). For this line item, the IRS wants to see exactly how much your top five highest-paid employees are getting paid if they make more than \$50,000. Ignoring all the fine print of the excess benefit rules and regulations, just remember that the salary and other benefits you pay each employee should be no more than what a comparably paid person in a similar position in a similar organization would receive. With nonprofit symphony orchestra leaders getting paid millions in annual salaries, it is questionable that using a comparability standard always produces the best or even reasonable results. And we’re sure that readers of this book, who work long, hard hours getting paid less than they should in pursuit of their public purposes, should have little to worry about when it comes to the question of receiving unreasonably large salaries or other excess benefits from their nonprofit.

Line 1(c): Indicate the names of individuals (or names of businesses), titles (if individual), mailing addresses, and compensation for your five highest-paid independent contractors who will earn more than \$50,000 per year. Independent contractors are people

and companies who provide nonemployee services to the nonprofit, such as a paid lawyer, accountant, outside bookkeeper, financial consultant, fundraiser, and other outside individuals and companies hired by the nonprofit who are not on the nonprofit’s employee payroll. Typically, your nonprofit will have a separate contract for services with its independent contractors—particularly if it will pay them more than \$50,000 per year. If your newly formed nonprofit has plans to contract more than \$50,000 with one or more outside individuals or companies, list them here and provide the expected amount of business you plan to do with each contractor annually. If, as is typical, your newly formed nonprofit does not have plans to contract for outside services, you can respond (in the blanks or on an attachment) as follows: “This newly formed nonprofit corporation has no current plans to contract for services with outside persons or companies. If and when it does, any such contracts will provide for payment in commercially reasonable amounts in return for services related to the exempt functions of this nonprofit.”

Lines 2(a)–9(a): The remaining questions in this Part V seek to determine if your nonprofit may run afoul of the excess benefit restrictions that apply to 501(c)(3) public charities—the type of nonprofit you are trying to establish. The excess benefit rules apply to “disqualified persons,” as defined under the Internal Revenue Code, Section 4958. For these purposes, a disqualified person means anyone who exercises substantial influence over the nonprofit, such as founders, directors, officers, and substantial contributors. People who fall within the definition of disqualified persons are not prohibited from being paid by your nonprofit. Instead, their salaries and benefits are subject to scrutiny under the excess benefit rules. If the IRS finds

that a disqualified person was overpaid—that is, the person received a salary, bonus, or benefits that exceeded the fair market value of the services provided or was excessive compared to amounts paid to similar people in other nonprofits—the disqualified person and the nonprofit and its managers can be subject to sanctions. The sanctions include being required to pay back previously paid salaries and stiff penalty taxes. (For more information on disqualified persons and the excess benefit rules, see “Limitation on Profits and Benefits” in Chapter 3.)

The IRS will review your answers in this section to see if there is any indication that an intentional or incidental purpose of your nonprofit is to financially benefit the private interests of any board members, officers, employees, or contractors. If the IRS determines that you are using nonprofit funds to excessively compensate any of these people, it will deny your tax exemption.

If you answer “yes” to any of the remaining items in Part V, make sure to explain your response. Provide any additional information needed to show why you marked “yes” on an attachment page.



TIP

There are numerous definitions of “disqualified persons” in the Internal Revenue Code. Don’t get confused or concerned if you run up against different definitions of “disqualified persons” that apply to nonprofits. For example, a different definition of disqualified person (under IRC § 4946) is used to determine permitted sources of public support for 501(c)(3) public charity support tests and when applying the excise tax restrictions that apply to private foundations (see Chapter 4 and “Who Are Disqualified Persons?” below in this chapter).

Line 2(a): Check “yes” if any of your directors or officers are related to each other or have a business relationship with one another. A family relationship includes an individual’s spouse, ancestors, children, brothers, and sisters (see the instructions to Form 1023 for a description of family and business relationships that must be disclosed). If you check “yes,” provide a list of names and a description of the family or business relationship between the individuals on an attachment page.

Line 2(b): Check “yes” if your organization (“you” means your nonprofit) has an outside business relationship with its directors or officers (see the Form 1023 instructions for the types of business relationships that must be disclosed). Again, these relationships will not be an absolute bar to your obtaining a tax exemption, but the IRS will scrutinize payments made to these “related” parties to make sure they are being fairly, not excessively, compensated by your nonprofit (either through salaries and benefits or through separate business contracts with your nonprofit). Of course, it looks best if your board and officers do not have an outside business relationship with your nonprofit—and we expect, even just for appearances’ sake, that most smaller nonprofits will not appoint board members or officers with whom the nonprofit plans to do outside business. If you check “yes,” disclose the names of the individuals and their business relationships with your nonprofit on an attachment page.

Line 2(c): This item asks if any of your directors or officers are related to the people listed in 1(b) or 1(c)—that is, related to your highest-paid employees or independent contractors who make more than \$50,000. If you answer “yes,” specify the names of the directors and officers and their relationship to the highest-paid people. Again, it looks best if your board

and officers are not related to your more highly compensated employees or contractors. But in the real world of small nonprofits, it may be impossible to start your nonprofit without getting Uncle Bill or Aunt Sally to provide their expertise by volunteering as an unpaid board member. As long as you disclose these arrangements and make sure to fairly pay—and not overpay—anyone, the IRS should conclude that your nonprofit is on the up-and-up and is entitled to its exemption if it meets all the substantive requirements.

Line 3(a): This item requests very important information (on an attachment page), which the IRS uses to determine if your nonprofit will pay excessive benefits to any insider or outsider. Specifically, it asks you to list the qualifications, average hours worked (or to be worked), and duties of your directors and officers listed in 1(a) and highly compensated employees and contractors (listed in 1(b) and 1(c), respectively). Your responses here should justify any high salaries, benefits, or per diem amounts paid to your officers or directors. For example, if you plan to pay officers a significant salary that may raise IRS examiner eyebrows, make sure to list the extra qualifications and experience of the highly compensated officer. Don't hold back or be shy in touting the credentials (academic degrees, teaching positions, awards), experience (past associations as advisers or directors with other nonprofits), and other qualifications or community affiliations of your well-paid people. The IRS really wants to know why you pay people well (if, in fact, you are lucky enough to pay or plan to pay your officers and other employees a competitive wage, salary, or benefits). On the flip side, obviously, if you pay your part-time administrative aid, who just happens to be your cousin Joe, a lavish hourly wage plus full

benefits, expect the IRS to balk. Unless Joe has special skills that are in high demand by other organizations and companies, the IRS will question this special arrangement.

Line 3(b): If any of the directors, officers, and highly paid people listed in 1(a) through 1(c) get paid by another organization or company that has “common control” with your nonprofit, you will need to mark “yes” on this item and provide an explanation on an attachment page. As the instructions to Form 1023 explain, organizations with common control include those that have their boards or officers appointed or elected by the same parent or overseeing organization. In addition, if a majority of your board and/or officers and a majority of the board and/or officers of another organization consist of the same individuals, then you share common control. If common control between your nonprofit and another organization exists, expect the IRS to attribute the total compensation paid by both commonly controlled organizations to your board and officers, and also expect the IRS to judge the purposes and activities of your nonprofit in light of the control exercised or shared by the other organization. For example, if a majority of your officers are officers of another nonprofit, the IRS will want to know whether your nonprofit exists to serve the purposes or foster the activities of the related nonprofit. This may be fine if the other nonprofit is, itself, a 501(c)(3) tax-exempt nonprofit. But if it isn't, the common control aspect probably will adversely affect your ability to obtain your tax exemption—your nonprofit can't be formed to promote nonexempt purposes.

Lines 4(a)–4(g): This item asks whether your group has established the procedures and practices recommended under the safe harbor rules of the excess benefit provisions and regulations (see “Limitation on Profits and

Benefits,” in Chapter 3, for a brief summary of the safe harbor rules). These procedures are meant to minimize the risk that nonprofits will pay out excess benefits. You don’t have to adopt and follow them, but you should if you want the IRS to look kindly on your tax exemption.

If you adopt the standard bylaws contained in this book, you can mark “yes” to each question and provide the responses to each item shown below on an attachment page. The IRS instructions to this line do not ask for more information if you answer “yes” to an item, but we think you should offer more, stating in your response where the IRS can look in your bylaws to verify that you have adopted each practice (as explained for each item, below).

Line 4(a): Check “yes” and state on an attachment page: “This organization has adopted a conflict of interest policy that controls the approval of salaries to directors, officers, and other ‘disqualified persons’ as defined in Section 4958 of the Internal Revenue Code. See Article 9, as well as Article 3, Section 6, and Article 4, Section 10, of the bylaws attached to this application. Also, Article 9, Section 5, of this organization’s bylaws applies additional conflict of interest requirements on the board and compensation committee when approving compensation arrangements.”

Line 4(b): Check “yes” and state on an attachment page: “Article 9, Section 3, of this organization’s bylaws requires the approval of compensation of directors, officers, and any ‘disqualified person’ as defined in Section 4958 of the Internal Revenue Code in advance after full disclosure of the surrounding facts and approval by disinterested members of the governing board or committee and prior to entering into the compensation agreement or arrangement. Further, Article 9, Section 5(a), of this organization’s bylaws requires specific

approval of compensation arrangements prior to the first payment of compensation under such arrangements.”

Line 4(c): Check “yes” and state on an attachment page: “Article 9, Section 4, of the organization’s bylaws, which are attached to this application, require the taking of written minutes of meetings at which compensation paid to any director, officer, or other ‘disqualified person’ as defined in Section 4958 of the Internal Revenue Code, are approved. The minutes must include the date and the terms of the approved compensation arrangements. Further, and specifically with respect to the approval by the board or compensation committee of compensation arrangements, Article 9, Section 5(d), of the organization’s bylaws requires the recordation of the date and terms of compensation arrangements as well as other specific information concerning the basis for the approval of compensation arrangements.”

Line 4(d): Check “yes” and state on an attachment page: “Article 9, Section 4, of the organization’s bylaws requires the written recordation of the approval of compensation and other financial arrangements between this organization and a director, officer, employee, contractor, and any other ‘disqualified person’ as defined in Section 4958 of the Internal Revenue Code, including the names of the persons who vote on the arrangement and their votes. Further, and specifically with respect to the approval by the board or compensation committee of compensation arrangements, Article 9, Section 5(d), of the organization’s bylaws requires the recordation of the board or committee who were present during discussion of the approval of compensation arrangements, those who voted on it, and the votes cast by each board or committee member.”

Line 4(e): Check “yes” and state on an attachment page: “Article 9, Section 5(c), of the organization’s bylaws requires that the board or compensation committee considering the approval of a compensation arrangement obtain compensation levels paid by similarly situated organizations, both taxable and tax-exempt, for functionally comparable positions; the availability of similar services in the geographic area of this organization; current compensation surveys compiled by independent firms; and actual written offers from similar institutions competing for the services of the person who is the subject of the compensation arrangement. This article also provides that it is sufficient for these purposes to rely on compensation data obtained from three comparable organizations in the same or similar communities for similar services if this organization’s three-years’ average gross receipts are less than \$1 million (as allowed by IRS Regulation 53.4958-6).”

Line 4(f): Check “yes” and state on an attachment page: “Article 9, Section 5(d), of the organization’s bylaws requires that the written minutes of the board or compensation committee meeting at which a compensation arrangement was discussed and approved include the terms of compensation and the basis for its approval. This bylaw provision includes a list of specific information that must be included in the required written minutes.”

If you haven’t adopted the bylaws included with this book or have deleted or changed the provisions in Article 9 of the bylaws, you may need to mark “no” to one or more of the items in line 4. And whether you mark “yes” or “no,” you will need to provide responses on an attachment page that explains your particular conflicts of interest and compensation approval standards and procedures. Your responses should be sufficient to convince the IRS that your directors, officers, employees, and contractors

will be paid fairly for work done to further your organization’s exempt purposes and that disinterested directors or compensation committee members—for example, nonpaid directors or committee members who are not related to anyone paid by your organization—set the salaries and other compensation of your officers, employees, and contractors.

Line 4(g): You should have marked “Yes” to all items in 4(a)–(f), but if you didn’t, you will need to add an attachment response that explains how you set reasonable compensation for people listed in Part V, 1(a)–1(c).

Lines 5(a)–5(c): Mark “yes” if you have adopted the bylaws included with this book. State on the attachment page for this item: “The board of directors of this organization has adopted bylaws that contain a conflicts of interest policy. The policy is set out in Article 9 of the attached bylaws. This policy is based on the sample conflict of interest policy contained in Appendix A of the official instructions to IRS Form 1023. The organization has added additional requirements in Article 9, Section 5, of its bylaws for the approval of compensation arrangements that are based on the additional requirements contained in IRS Regulation 53.4958-6 to help ensure that all compensation arrangements are made by disinterested members of the organization’s board or a duly constituted compensation committee of the board and are fair, reasonable, and in furtherance of the tax-exempt purposes of this organization.”

If you mark “yes” to 5(a), you can skip 5(b) and 5(c). If you marked “no” to 5(a) because you did not adopt the bylaws included with this book or changed them to adopt a different conflict of interest policy, include responses to questions 5(a) and 5(b) on an attachment page. Your responses should show that you will follow your own practices to make sure that your

directors, officers, employees, and others who exert significant influence over your nonprofit cannot feather their own nests by setting their own salary levels and making their own self-serving business deals with your nonprofit.

Lines 6(a)–6(b): The IRS instructions to Form 1023 explain what the terms “fixed payment” and “non-fixed payment” mean. Essentially, question 6(a) asks if your organization will pay its directors, officers, highly paid employees, or highly paid contractors (those listed in this part, lines 1(a) through 1(c)) any discretionary amounts (such as bonuses) or amounts based on your organization’s revenues (such as a salary kicker or bonus computed as a percentage of annual contributions received by your nonprofit). Question 6(b) asks this same question with respect to all the other employees of your nonprofit who receive compensation of more than \$50,000 per year. Obviously, it looks best if your nonprofit’s principals and employees do not receive these types of revenue-driven incentives, which are more typical in a business, not a nonprofit, setting. We assume most small nonprofits will be able to answer “no” to this question. If, however, you have an overriding need to pay directors, officers, and employees discretionary bonuses or provide them with revenue- or performance-based compensation or commissions, you need to provide the information requested on an attachment page. Your response should show that these nonfixed payments will be fairly and reasonably paid as incentives to promote the nonprofit purposes of your organization (this may not be easy to show), and that it won’t be used simply to pay out revenues to your principals. Remember—private inurement is a nonprofit no-no—so siphoning over revenue to nonprofit principals is not allowed, even in the guise of bonus or performance-based employee incentives.

Lines 7(a)–7(b): Question 7(a) asks if your organization will purchase goods, services, or assets from its directors, officers, highly paid employees, or highly paid contractors (those listed in this Part V, lines 1(a)–1(c)). Question 7(b) asks if your organization will sell goods, services, or assets to these people.

Most nonprofits will be able to answer “no” to both these questions because they will want to stay clear of insider sales and purchase transactions, simply to avoid the appearance (if not the actuality) of self-dealing. That said, it’s also a fact of life that some smaller nonprofits have to look to their directors, officers, and principal employees or contractors to buy or sell goods or services: These may be the only people willing to do business with the nonprofit at the start of its operations. Even more typically, a small nonprofit may want to buy goods at a special discount offered by a director or an officer. If you answer “yes” to one of these questions, provide the requested information in your response on an attachment page. Your response should make clear that any such purchases or sales will be at arm’s length—that is, your nonprofit will pay no more and sell at no less than the commercially competitive, fair market value price for the goods, services, or assets. If you plan to buy goods, services, or assets at a discount from a director, an officer, an employee, or a contractor, make sure to say so, since this sort of bargain purchase is better than an arm’s-length deal from the perspective of the nonprofit.

The official instructions to Form 1023, lines 7(a) and 7(b), indicate that you can ignore purchases and sales of goods and services in the normal course of operations that are available to the general public under similar terms or conditions. In other words, if you buy normal inventory items from a contractor listed in

Part V, line 1(c), at standard terms paid by the general public for these inventory items, you do not have to mark “yes” to 7(a). Frankly, if your organization plans to purchase any type of goods or services from a director, an officer, or an employee, we think it should be disclosed in your application, since a deal of this sort may have the appearance of a self-dealing transaction. In such a case, you can check “yes” to line 7(a), then make it clear in your response that your organization will pay the same price for the inventory or other standard items purchased from a director, an officer, or an employee as the price paid by the general public (the current commercially competitive fair market value price).

If you answer “yes” to either question and have adopted the bylaws included with this book, you can add in your response that “Article 9, Section 3, of the organization’s bylaws requires the approval of conflict-of-interest transactions or arrangements, such as the purchase or sale of goods, services, or assets between the organization and one of its directors, officers, or any other ‘disqualified person’ as defined in Section 4958(f)(1) of the Internal Revenue Code and as amplified by Section 53.4958-3 of the IRS Regulations, by the vote of a majority of disinterested directors or members of a board committee, only after a finding that a more advantageous transaction or arrangement is not available to the organization and that the proposed transaction or arrangement is in the organization’s best interest, is for its own benefit, and is fair and reasonable.”

Lines 8(a)–8(f): Question 8(a) asks if your organization will enter into leases, contracts, or other agreements with its directors, officers, highly paid employees, or highly paid contractors (those listed in this part, lines 1(a) through (c)). If you answer “yes,” you must supply responses to items 8(b) through 8(f) on an attachment page.

To rephrase an observation made in the instructions to line 7, above, to avoid the appearance if not the actuality of self-dealing, it’s best not to deal with nonprofit insiders when leasing property or contracting for goods, services, or making other business arrangements. Most nonprofits will shy away from doing this, and will answer “no” to 8(a).

However, newly formed nonprofits sometimes find it most practical (and economical) to lease or rent property owned by a founder, a director, or an officer, or may otherwise have to enter into a contract or an arrangement with one of these people. There is nothing absolutely forbidden about doing so, but you will want to make sure that any lease, contract, or agreement between your nonprofit and one of these people reflects fair market value terms or better. For example, it looks best if a director leases property owned by the director to the nonprofit at a lower-than-market-value rate (best of all, of course, is when the director lets the nonprofit use the lease premises rent free).

If you answer “yes” to 8(a), provide the information requested in 8(b) through 8(f) on an attachment page. If possible, attach a copy of any lease, rental, or other agreement as requested in 8(f). For a discussion of leases together with a sample assignment of lease, see “Prepare Assignments of Leases and Deeds” in Chapter 9. Also, if you have adopted the bylaws included with this book, you can add in your response to item 8(d) or 8(e) that “Article 9, Section 3, of the organization’s bylaws requires the approval of conflict-of-interest transactions or arrangements, such as a lease, a contract, or another agreement between this organization and any of its directors, officers, or any other ‘disqualified person’ as defined in Section 4958(f)(1) of the Internal Revenue Code and as amplified by Section 53.4958-3 of the IRS Regulations, by the vote of a majority of disinterested directors or members of a board

committee, only after a finding that a more advantageous transaction or arrangement is not available to the organization and that the proposed transaction or arrangement is in the organization's best interest, is for its own benefit, and is fair and reasonable."

Lines 9(a)–9(f): These questions are similar to those in 8(a) through 8(f) above, except they apply to leases, contracts, and agreements between your nonprofit and another business or organization associated with or controlled by your directors or officers. Specifically, these questions apply to business deals between your nonprofit and another company or organization in which one or more of your directors or officers also serves as a director or an officer or one of your directors or officers owns a 35% or greater interest (for example, a 35% voting stock ownership interest in a profit-making corporation). You can ignore deals made between your corporation and another 501(c)(3) tax-exempt nonprofit organization, even if one or more of your directors or officers also serves on the board or as an officer of the other 501(c)(3) tax-exempt nonprofit organization.

EXAMPLE 1: If one of your directors also serves as a board member on a nonprofit cooperative that is not tax exempt under 501(c)(3) and your nonprofit enters into leases, contracts, or other agreements with the other nonprofit, answer "yes" to 9(a) and provide the information requested in items 9(b) through 9(f).

EXAMPLE 2: If one of your officers owns a 35% or greater stock interest in a business corporation, and your nonprofit buys goods and services from the business corporation (either through a formal contract or a verbal agreement), answer "yes" to 9(a) and provide the information requested in items 9(b) through 9(f).

The discussion in line 8, above, about leases and agreements between your nonprofit and individuals applies here to leases and agreements between your nonprofit and affiliated or controlled companies and organizations. If you answer "yes," provide the information requested in items 9(b) through 9(f). Also, if you have adopted the bylaws included with this book, you can add in your response to item 9(d) or 9(e) that "Article 9, Section 3, of the organization's bylaws requires the approval of conflict-of-interest transactions or arrangements, such as a lease, a contract, or another agreement between this organization and any 'disqualified person' as defined in Section 4958(f)(1) of the Internal Revenue Code and as amplified by Section 53.4958-3 of the IRS Regulations, which includes 35% controlled entities, by the vote of a majority of disinterested directors or members of a board committee, only after a finding that a more advantageous transaction or arrangement is not available to the organization and that the proposed transaction or arrangement is in the organization's best interest, is for its own benefit, and is fair and reasonable."

Part VI: Your Members and Other Individuals and Organizations That Receive Benefits From You

Line 1(a): If you plan to implement programs that provide goods, services, or funds to individuals, check "yes" and describe these programs on an attachment page. Many smaller nonprofits will provide goods or services as part of their exempt purpose activities, such as a nonprofit dance studio (dance lessons or admissions to dance performances), formal and informal nonprofit schools (tuition or fees for classes and instructional services), hospitals (health care costs), and other educational or charitable groups. Of course, charitable purpose groups often provide

goods or services free to the public or at lower than market-rate cost—such as free or low-cost meals, shelter, and clothing. But educational purpose groups often charge standard or slightly reduced rates for admissions, tuition, and services. Doing the latter is permissible. What the IRS wants to see is that your nonprofit is set up to provide goods and services as part of a valid nonprofit tax-exempt program, and that all members of the public—or at least a segment of the public that is not limited to particular individuals—will have access to your goods or services. What you can't do is set up a tax-exempt nonprofit that intends to benefit a private class or specific group of individuals, as individuals (such as your Uncle Bob and Aunt Betty, or all your relatives and in-laws). The broader the class of people that your nonprofit benefits, the better. Making your nonprofit programs available to the public at large normally looks best to the IRS. And providing goods and services at rates below market rates also helps bolster your credibility as a nonprofit, as opposed to a revenue-driven organization.

At this point in the process, most groups have not fully determined what they will charge for goods and services. If this is the case, describe in your response the services and benefits that will be provided to the public (or a segment of the public) and explain generally how you will determine fees. For example, you may wish to indicate that “charges for the described benefits, products, and services are at present undetermined, but will be reasonable and related to the cost of the service to be provided.” And again, if you plan to provide goods or services at a discount or free of charge, make sure you say so.

Line 1(b): If your nonprofit will provide goods or services to other organizations, check “yes” and describe your program plans on an attachment page. If you donate or sell goods and services to another 501(c)(3) tax-exempt

nonprofit at fair or discounted rates for use in their tax-exempt programs, your program should pass muster with the IRS. But if you simply plan to obtain revenue by selling goods and services provided to profit-making businesses, expect to have to justify this sort of commercial-looking activity. For example, an educational group may provide seminars to the human resource managers of business corporations on how to comply with federal and state fair employment regulations. This sort of program that serves the needs of employees should be fine with the IRS. But simply trafficking in goods and services for a profit with other organizations and companies will look like (and probably is, in fact) a commercially driven, profit-making enterprise that won't qualify as a tax-exempt activity.

Line 2: Most groups will answer “no” to this question because the IRS frowns on groups that limit benefits, services, or funds to a specific individual or group of individuals. However, if the group of people benefited by the nonprofit is broad (not limited to specific individuals) and related to the exempt purposes of the nonprofit group, the IRS should have no objection (see the discussion to line 1(a) of this part, above). If you answer “yes,” provide an explanation on an attachment page. You may be able to refer to information already provided in your response to line 1(a) of this part.

EXAMPLE: A nonprofit musical heritage organization plans to provide programs and benefits to needy musicians residing in the community. If the overall tax-exempt purpose of the organization is allowed, the IRS will permit this limitation of benefits to a segment of the community.

Line 3: In this question, the IRS is looking for prohibited self-inurement—in this case, whether your nonprofit is set up primarily or directly to provide goods, services, or funds

to individuals who have a family or business relationship with your directors, officers, or highest-paid employees or contractors listed in Part V, lines 1(a) through 1(c). Most groups will answer “no” here. However, if you think someone who fits in one of these categories may receive goods, products, or services incidentally from your nonprofit as a member of the public, check “yes” and explain how these related people will have access to your nonprofit’s benefits. If your response makes it clear that these related people are not the focus of your nonprofit programs, but as members of the general public only coincidentally qualify, you should be okay.

Part VII: Your History

Line 1: Most groups will answer “no” to this question. However, if you are a successor to an incorporated or a preexisting organization (such as an unincorporated association), mark “yes.”

Successor has a special technical meaning, which is explained in the official IRS instructions to this item. Basically, you are most likely to be a successor organization if your nonprofit corporation has:

- taken over the activities of a prior organization—this is presumably the case if your nonprofit corporation has appointed initial directors or officers who are the same people who served as the directors or officers of the prior association, and your nonprofit has the same purposes as the prior association
- taken over 25% or more of the assets of a preexisting nonprofit, or
- been legally converted from the previous association to a nonprofit—typically by filing special articles of incorporation to state the name of the prior association and a declaration by the prior officers of the association that the conversion to a nonprofit corporation was properly

approved by the association, or by filing articles of conversion to convert a profit-making entity to your new nonprofit corporation.

We assume most readers will be starting new nonprofits, not inheriting the assets, people, and activities of a preexisting formal nonprofit association. We also assume most readers have not adopted special articles to legally convert a prior association or profit-making entity to a nonprofit corporation. In the real world, this formal conversion of a prior association to a nonprofit corporation only occurs if the prior group was a highly organized and visible entity with a solid support base that it wants to leverage by formally converting the association to a nonprofit corporation. However, in most cases, a small nonprofit that existed previously as an informal nonprofit group with few assets, little support, and hardly any formal infrastructure normally starts out fresh with a newly formed corporation that is not a successor to the prior group. If you think your nonprofit corporation is a “successor” organization, we suggest you get help from a nonprofit expert to complete Schedule G and make sure all the paperwork for your new nonprofit as well as the prior group is in order.

If you are a successor to a prior organization, mark “yes,” and complete Schedule G of the 1023 application. (See “Filling Out the Schedules,” below, for instructions on filling out Schedule G.) The IRS will take the history, activities, and financial data of your prior organization as well as your responses to Schedule G into account when deciding whether your nonprofit corporation is entitled to its tax exemption. It may also ask you to file tax returns for the prior organization if it has not already done so for all preceding tax years during which the prior nonexempt organization was in operation.

Line 2: Most new groups will be able to answer “no” here because they will be submitting their exemption application within 27 months after the end of month when their nonprofit corporation was formed. The date of formation is the date the corporation’s articles of incorporation were filed by the secretary of state and became effective. For example, if you filed your articles on January 12, 2017 you have until the end of April 2019 to submit (postmark) your exemption application.

If you are submitting your exemption application after this 27-month deadline, check “yes” and fill in and submit Schedule E with your 1023 exemption application. (See “Filling Out the Schedules,” below, for instructions on completing Schedule E.)

Part VIII: Your Specific Activities

This part asks about certain types of activities, such as political activity and fundraising, that the IRS looks at more closely. These are activities that a 501(c)(3) is prohibited from engaging in or can do only within certain strict limitations—namely, without benefiting or catering to the special interests of particular individuals or organizations. Please read the official instructions to this Part in the 1023 instructions before reading our instructions below.

Line 1: A 501(c)(3) nonprofit organization may not participate in political campaigns (although some voter education drives and political debate activities are permitted—see “Limitation on Political Activities” in Chapter 3). The IRS may deny or revoke your tax-exempt status if you participate in or donate to a campaign. Most groups should answer “no” here.

If you think you should answer “yes” to this question, check with a nonprofit lawyer or tax consultant—a “yes” response means you do not qualify for a 501(c)(3) tax exemption. However, you may qualify for a 501(c)(4) tax exemption.

Line 2(a): This question concerns your group’s plans, if any, to affect legislation. Most groups will answer “no” to this question. If you answer “no,” you can move on to line 3.

If you plan to engage in efforts to influence legislation, check “yes” and read the discussion in “Limitation on Political Activities,” in Chapter 3. Then complete 2(b).

Line 2(b): Check “yes” if you plan to elect to fall under the alternate political expenditures test discussed in “Limitation on Political Activities,” in Chapter 3, and attach a completed IRS Form 5768, *Election/Revocation of Election by an Eligible Section 501(c)(3) Organization To Make Expenditures To Influence Legislation*. We assume you have not already filed this form; if you have, attach a copy of the filed form. The political expenditures test is complicated, and you’ll probably need the help of a seasoned nonprofit adviser to decide whether you will be able to meet the requirements and gain a benefit from electing this special test for political legislative activities. Before using Form 5768, go to the IRS website, at www.irs.gov, and make sure it is the latest version of the form. If the IRS site has a more current version, use that form.

If you checked “yes” to line 2(a) and do not plan to elect the political expenditures test, check “no” to line 2(b). On an attachment, you must describe the extent and percentage of time and money you expect to devote to your legislative activities compared to your total activities. Be as specific as you can about the political activities you expect to promote and how you will promote them. If possible (and accurate), make it clear that your legislative activities will make up an “insubstantial” part of your overall nonprofit programs and activities. If the IRS feels that your political program will be substantial, it will deny your 501(c)(3) tax exemption.

Lines 3(a)–3(c): Most 501(c)(3) nonprofits do not engage in bingo and gaming activities. If you plan to do so, read the IRS official instruction for this line as well as IRS Publication 3079, *Tax-Exempt Organizations and Gaming*, before checking “yes” to any of the questions in line 3 and providing the requested information.

Line 4(a): Read the official instructions to this line to learn the definition of fundraising and some of the different ways it may be conducted. Note that fundraising includes raising funds for your own organization, raising funds for other organizations, as well as having some other individual or organization raise funds for your group. If your nonprofit is one that will be obtaining revenue and operating funds only from the performance of its exempt functions—that is, by providing services or goods related to your exempt purpose—you can check “no” here. Make sure that none of the specific fundraising activity boxes listed in 4(a) apply to your group. However, if you expect your nonprofit to do any type of fundraising, such as soliciting government grants, attracting private and public donations or contributions, or going whole hog and hiring a professional fundraiser, check “yes” and then check each box that describes a fundraising activity that you plan to or may pursue in your quest for program funds and revenue. On an attachment page, describe each activity whose box you have checked. If your nonprofit plans to engage in a type of fundraising not listed under 4(a), check the “other” box and describe it in your attachment response. Be as specific and as thorough as you can in your response about the people you will use, any compensation you will pay, the amount and type of support you hope to raise, and the use to which you will put raised funds for each fundraising activity. If you check “no” to 4(a), you can skip ahead to line 5.

Line 4(b): Mark “yes” if you plan to hire paid fundraisers, and provide the financial and contract information requested on an attachment page. Any financial information should be actual or projected figures that cover the same periods as the financial information you will provide in Part IX (see the official 1023 Part IX instructions and our Part IX instructions, below, to determine the period for which you should provide financial information). Many beginning nonprofits will not plan to use paid fundraisers right away and can state: “This newly formed nonprofit has not entered into oral or written contracts with individuals or organizations for the raising of funds, and has no specific plans to do so in the foreseeable future.”

Line 4(c): If your nonprofit will do fundraising for other organizations, state “yes” and provide the information requested on an attachment page. Most nonprofit organizers using this book will not raise funds for other organizations even if they plan to raise funds for themselves and will mark “no” here.

Line 4(d): If you checked “yes” to 4(a), provide the information requested for this item. You should provide this information for states or localities where you will raise funds for your organization or for other organizations, or where an individual or another organization, including a paid fundraiser, will raise funds for your organization.

Line 4(e): See the official instructions for this item—it concerns the special practice of soliciting and using “donor-advised” or “donor-directed” funds. Most nonprofits will not have plans to use this practice, but if you do, provide the information requested on an attachment page. The IRS will want to make sure that your organization does not use funds to meet the private needs of donors, but instead will use donor-directed funds for purposes that are consistent with the tax-exempt purposes of the nonprofit.

Here is a statement from the 2005 IRS *Exempt Organization (EO) Report* that explains why the IRS is concerned about donor-advised funds, and indicates that it will be keeping an eye out for abuse in this area:

Donor-advised funds allow private donors to provide input as to how their charitable contributions will be spent. A number of organizations have come to light through examinations, referrals from other parts of the IRS, and public scrutiny which appear to have abused the basic concepts underlying donor-advised funds. These organizations, while promoted as legitimate donor-advised funds, appear to be established for the purpose of generating questionable charitable deductions, providing impermissible economic benefits to the donors and their families (including tax-sheltered investment income for the donors), and providing management fees for the promoters. EO Examinations will identify organizations with a high potential for abuse in this area and commence examinations during FY 2005.

Line 5: This item is for special government-affiliated groups (see the instructions to the 1023 form). If you check “yes,” your nonprofit needs special assistance responding to this item and being able to meet the requirements for a 501(c)(3) tax exemption. If you check “yes,” consult a nonprofit legal adviser.

Line 6(a)–(b): See the 1023 instructions. If you are an economic development nonprofit and mark “yes,” you’ll need expert help filling out your tax exemption to make sure your activities meet the 501(c)(3) requirements.

Below is a statement from the 2005 IRS *Exempt Organization (EO) Report* that explains why the IRS is applying special scrutiny to economic development nonprofits:

In response to referrals from HUD concerning abuse by individuals setting up exempt organizations for the purpose of participating in a number of HUD programs, EO initiated a compliance project in this area in FY 2004. Potential abuses include lack of charitable activity, personal use of program property, and most often, private benefit provided to for-profit construction contractors hired to complete the repairs to program properties. In these cases, contractors were usually related to the organizations’ officers or board members, and were often the same individuals. Costs were overstated and work was substandard or completely lacking. The project is currently focusing on abuses by exempt organizations in HUD’s housing rehabilitation/resale and down payment assistance programs, and will expand to other HUD programs as staffing permits.

Line 7(a): Line 7 applies to a nonprofit that will own or develop real estate, such as land or a building, in pursuit of its nonprofit activities. See the 1023 instructions for lines 7(a) through 7(c) for more information. If you plan to develop or improve real estate, including land or buildings, mark “yes” to 7(a) and provide the information requested on an attachment page. Mostly the IRS wants to make sure that your nonprofit is not planning to make any “sweetheart” real estate development deals that benefit people associated with your nonprofit and its directors and officers through family or business ties.

Line 7(b): If your nonprofit will maintain facilities, such as a building or an office space or another physical address, and plans to use anyone other than employees or volunteers to manage the facilities—for example, if it plans to hire a management company to manage property—check “yes” and provide the information

requested on an attachment page. Again, the IRS wants you to show that the managers are not getting special breaks or excess payments because they are family members or business associates of the nonprofit's directors or officers.

Line 7(c): This line wants you to provide information on all developers and managers of real estate or facilities owned or used by your nonprofit if any of these developers or managers have a business or family relationship with your nonprofit directors or officers. If this question applies to your nonprofit, provide the information requested on an attachment page. If you have already provided the information in response to 7(a) and/or 7(b), you can refer to your previous response. The IRS will scrutinize any contracts you provide and negotiation processes you describe to make sure your nonprofit is not paying more than fair market value for real property development and management services.

Line 8: First read the 1023 instructions for this line. If your nonprofit plans to enter into joint ventures (business deals) with individuals or other nonprofits or commercial business entities, see a legal adviser before providing the information requested and completing your 1023 tax exemption application. Nonprofit organization joint ventures raise complex issues that require expert help to make sure they are structured properly to meet the requirements of the 501(c)(3) tax exemption.

Lines 9(a)–9(d): If you are forming a child care organization, you may qualify for your tax exemption either under 501(k) of the Internal Revenue Code or 501(c)(3) as a school. Read the instructions before answering these questions. If you check “yes” to 9(a), answer 9(b) through 9(d). If you answer “no,” go on to line 10.

Line 10: This question asks if your nonprofit plans to publish, own, or have rights in intellectual property, such as art, books, patents, trademarks, and the like (see the 1023 instructions for definitions). If you answer “yes,” provide the information requested on an attachment page about ownership of the intellectual property, if and how you will derive revenue from the property, and generally how the property will be used as part of your nonprofit activities. In essence, the IRS wants to know whether your nonprofit plans to acquire and exploit copyrights, patents, and other forms of intellectual property and, if so, how. Examples of groups that would answer “yes” include a visual arts exhibit studio, an educational book publisher, a scientific research center that engages in original (patentable) research, and any group that plans to market its trade name (a name used by the nonprofit and associated with its activities), trademark, or service mark (logos, words, and images used by the nonprofit to market its goods and services).

501(c)(3) nonprofits that conduct scientific research in the public interest are expected to make their patents, copyrights, processes, or formulae available to the public, not simply develop and exploit results of their research for their own use (see “Scientific Purposes” in Chapter 3). There is nothing wrong or underhanded, however, about a nonprofit owning and exploiting intellectual property related to its exempt purpose—for example, a qualified literary or education nonprofit's owning and obtaining royalty revenue from the sale of its published educational works, or a nonprofit's selling donated art to raise funds for its exempt purpose. Be careful, though: If a nonprofit deals in intellectual property as a routine method of raising operating

revenue—for example, if a nonprofit licenses its trade name to obtain revenue—the IRS is likely to consider this income unrelated business income. If this unrelated income is clearly more than a small portion of the group’s overall revenue, the IRS will likely question or deny the group’s 501(c)(3) tax exemption.

The issue of copyright ownership sometimes is key to this issue. Remember: If copyrights in published works are owned by a 501(c)(3) nonprofit, this means that the copyrights, like all other assets owned by the nonprofit, are irrevocably dedicated to tax-exempt purposes and must be distributed (transferred) to another tax-exempt nonprofit when the organization dissolves. Hence, the IRS is apt to look more favorably on an educational nonprofit that holds copyrights in its published works. Conversely, if a nonprofit education group does not own the copyright to its published works, but instead publishes the works owned by others under the terms of standard commercial royalty contracts, the IRS may feel that the group is simply a commercial publisher that is not entitled to a 501(c)(3) educational tax exemption. However, if the group publishes education material written by volunteers or its employees or under “work for hire” contracts with outside authors, copyrights in the works are owned by the nonprofit, not by the authors. Publication of this material is clearly in the public interest and contains content related to the educational purpose of the nonprofit. Thus, the IRS is more likely to agree that the group is entitled to a tax exemption.

The sale of art by nonprofits often piques the interest of IRS examiners. For example, if an educational nonprofit exhibits artwork owned by artists and collects a commission on each sale, the IRS may conclude that the

organization runs a commercial art gallery that is not entitled to a tax exemption. There is no bright-line test for groups that deal in art or sell goods and services. The IRS looks at all the facts and circumstances related to a group’s activities and operations to determine if the group’s primary purpose is a charitable, educational, or another 501(c)(3) purpose or, instead, represents a commercial enterprise. For examples of when the IRS has reached different conclusions after examining the activities of groups that sell art as part of their activities, see the summaries of selected IRS revenue rulings below:



TIP

How to read IRS revenue rulings. Each IRS revenue ruling is referenced with a two- or four-digit year prefix followed by a number—for example, revenue ruling 2004-98 is a 2004 ruling and revenue ruling 80-106 is a 1980 ruling. The rulings are distinguished from other rulings during the year by the second number.

- Rev. Rul. 80-106. Thrift shop; consignment sales. An organization operated a thrift shop that sold items that were either donated or received on consignment. Substantially all of the work in operating the thrift shop was performed without compensation, all transactions were at arm’s length, and all profits were distributed to Section 501(c)(3) organizations. The organization qualified for exemption as an organization operated for charitable purposes.
- Rev. Rul. 76-152. Art gallery. A nonprofit educational organization, formed by art patrons to promote community understanding of modern art trends by selecting for exhibit, exhibiting, and selling artworks of local artists, and which retained a

commission on sales that was less than customary commercial charges and was not sufficient to cover the cost of operating the gallery, did not qualify for exemption under Section 501(c)(3). The following statement in the ruling provides perhaps the best clue as to why the IRS rejected the group's application: "Since ninety percent of all sales proceeds are turned over to the individual artists, such direct benefits are substantial by any measure and the organization's provision of them cannot be dismissed as being merely incidental to its other purposes and activities."

- Rev. Rul. 71-395. Art selling. A cooperative art gallery, which was formed and operated by a group of artists for the purpose of exhibiting and selling their works, did not charge admission but received a commission from sales and rental of art sufficient to cover the cost of operating the gallery. It did not qualify for exemption under Section 501(c)(3) as an educational organization.
- Rev. Rul. 66-178. Art exhibits. A nonprofit organization was created to foster and develop the arts by sponsoring a public art exhibit at which the works of unknown but promising artists were selected by a panel of qualified judges for display. Artists eligible to have their works displayed were those who were not affiliated with art galleries and who had no medium for exhibiting their creations. The organization did not charge the artists any fees, nor did the organization sell or offer the displayed works for sale. For the exhibit, the organization prepared a catalog that listed each work displayed, the name of its creator, and the artist's home or studio address. The catalog was sold for a small fee to the public. The

organization also received income from nominal admission fees to the exhibit and from contributions. Funds were paid out for renting the exhibition hall, printing the catalogs, and administrative expenses. The organization qualified for a 501(c)(3) tax exemption.

If nothing else, the above rulings reinforce one fundamental fact about seeking and obtaining a tax exemption: The IRS looks at the full context of a nonprofit's operations—including its sources and uses of revenue—when deciding whether a group qualifies for 501(c)(3) tax exemption. Normally, no one fact is fatal or determinative. The more a group demonstrates that its operations are public rather than private or commercial, the better its chances of obtaining a tax exemption. And on a more subjective note, the above rulings also hint at the importance of couching your nonprofit activities in the most acceptable (least commercial) terms—for example, it may sound and look better to the IRS if your group collects admission or consignment fees rather than commissions, since the latter term typically connotes overt commercial activity.

Below are two revenue rulings related to educational nonprofits that involve the publication of books and music. The first repeats the theme that the more a group looks and acts like a regular commercial venture, the less its chances of qualifying for 501(c)(3) tax-exempt status. The second shows that nonprofits that cater to a small, traditionally noncommercial segment of public education stand a better chance of obtaining a tax exemption, at least partially because the nonprofit activity is, in fact, less likely to reap significant profits.

The two rulings provide as follows:

- **Rev. Rul. 66-104. Educational publishing.** An education organization was created to meet the need for more satisfactory teaching materials and textbooks in economics and related fields. The organization contracted with commercial publishing firms for the publication of these materials, which were used primarily by colleges and universities. The organization did not hold the copyright in its published material. The contracts between the organization and the publishers provided that the publishers pay all publication costs and a royalty to the organization on sales of the publication. In return, the publisher received the copyright, publishing, and selling rights. The agreement between the organization and the editors and authors provided that the royalty income would first be applied to pay for the costs of preparing the materials for publication, including funds to authors and editors. The remaining royalty was divided into specific percentages between the organization and the editors and authors. The IRS concluded that: “Although educational interests are served by the publication of better teaching materials, the facts in this case show only an enterprise conducted in an essentially commercial manner, in which all the participants expect to receive a monetary return.” The IRS denied the organization’s 501(c)(3) tax exemption.
- **Rev. Rul. 79-369. Musical recording.** The organization was created to stimulate, promote, encourage, and sustain interest in and appreciation of contemporary symphonic and chamber music. The organization recorded the new works of unrecognized composers as well as

the neglected works of more established composers. The music selected for recording had a limited commercial market and was not generally produced by the commercial music publishing and recording industry for sale to the public. The organization sold its recordings primarily to libraries and educational institutions. Some records were provided free to radio stations operated by educational institutions. The organization also made sales to individuals. The records were not made available for sale through commercial record dealers except in a few specialty shops, but were sold through mail orders. The organization did not engage in any advertising, but relied upon those who were interested in this type of music to communicate the availability of the records. All sales were facilitated by the use of a catalog published by the organization. The catalog contents included information about the compositions and the composers. This information was retained in the catalog so that the catalog served as an archive with respect to these compositions and recordings. Copies of all recordings were maintained for availability in the future. The liner notes on the album covers contained a biography of the composer and a description of the composition by its composer. Composers received royalties from the sale of recordings as required by federal law. Due to the limited commercial market for this type of music, the royalties received by the composers were not significant. The group qualified for a 501(c)(3) tax exemption.

Line 11: This question asks if your nonprofit will accept contributions of various types of property, including works of art and automobiles.

If you answer “yes,” provide the information requested. If you receive contributions of art, you may be able to refer to portions of your response to line 10, if you used that line to provide information on how you sell contributed art works. The IRS mostly wants to make sure your nonprofit is not simply setting up a contribution-conduit organization formed and operated primarily to generate income tax contributions for wealthy individuals associated with your group. See IRS Publication 526, *Charitable Contributions*, for the latest rules on the deductibility of contributions to qualified 501(c)(3) charities, available on the IRS website at www.irs.gov.

Lines 12(a)–12(d): If your nonprofit plans to operate in one or more foreign countries, answer “yes” to 12(a) and provide the information requested in 12(b) through 12(d) on an attachment page. Special tax-exemption and deductibility of contribution rules apply to nonprofits created or operated abroad. If you answer “yes,” see a nonprofit adviser who has experience in advising nonprofits that operate in the foreign countries where you plan to operate for help in completing your 1023 application. Also see “Foreign Organizations in General,” in the official 1023 instructions for basic information on nonprofits formed abroad. Finally, realize that a big part of the IRS’s energy is now devoted to scrutinizing the operations of foreign-based nonprofits as part of the Service’s participation in antiterrorism. Here is an excerpt from the IRS 2005 *EO (Exempt Organization) Report*:

In FY 2005, EO will examine a sample of foreign grant making organizations; the primary focus of the examinations is to ensure that funds are used for their intended charitable purpose and not diverted for terrorist activity. The project will

gather information about current practices, that is, the existence and effectiveness of controls put in place to monitor the distribution of overseas grants and other assistance. This committee will also address the need for possible guidance or other modifications to the laws in this area.

Lines 13(a)–13(g): If your nonprofit will make grants or loans to other organizations or receive and disburse funds (for example, as a fiscal agent) for other organizations, answer “yes” to line 13(a), then answer 13(b) through 13(g). Most smaller nonprofits do not make grants or loans to other nonprofits, but may receive grant money as fiscal agents for other nonprofits. If your group plans to do this, your responses should show that the groups you sponsor promote activities that are related to your tax-exempt purposes and that you exercise oversight in making sure the funds are accounted for and used properly by the groups you sponsor. If your responses demonstrate or imply that you disburse funds as a “feeder” group to promote regular commercial or nonexempt activities, the IRS will deny your exemption. The questions listed here should give you an indication of what the IRS is looking for—formal applications, grant proposals, fiscal reporting controls, and other procedures that you will use to select, monitor, and assess the groups that you sponsor.

Lines 14(a)–14(f): This question is similar to line 13, except it applies only to foreign groups that you assist or sponsor. If you answer “yes” to 14(a), it asks additional questions (14(b) through 14(f)) to make sure you apply extra scrutiny to any foreign groups you sponsor (see the antiterrorism note in the line 12 instructions, above—it is one of the drivers for this extra IRS scrutiny of groups that sponsor or assist foreign organizations).

Line 15: First read the instructions to this line in the official 1023 instructions. They provide a definition of what “close connection” means, and the definitions cover a lot of helpful material. If you answer “yes,” provide a thorough explanation on an attachment page of how your structure and/or operations are connected to those of another group. Obviously, if you do share space, people, programs, or other attributes or activities with another group, the IRS will want to see that you are not diverting your tax-exempt purposes or revenue to non-tax-exempt ends or purposes promoted by the group with which you are connected.

Line 16: See the instructions before answering this question. A cooperative hospital service organization is a very special type of organization that is tax exempt under Section 501(e) of the Internal Revenue Code, which like a 501(c)(3) group, uses the 1023 application to apply for its tax exemption. You will need expert help completing your tax exemption application if you answer “yes” here.

Line 17: See the instructions before answering this question. A cooperative service organization of operating educational organizations is another special type of organization that is tax exempt under Section 501(f) of the Internal Revenue Code. Like a 501(c)(3) group, it also uses the 1023 application to apply for its tax exemption. You will need expert help completing your tax exemption application if you answer “yes” here.

Line 18: We assume readers of this book are not setting up a charitable risk pool under Section 501(n) of the Internal Revenue Code (see the instructions to the 1023 form). If you are, get help from an expert in this special field of nonprofit activity before completing your tax exemption application.

Line 19: As explained in the 1023 instructions to this line, a school is defined as an educational

organization that has the primary function of presenting formal instruction, normally maintains a regular faculty and curriculum, normally has a regularly enrolled body of students, and has a place where its educational activities are carried on (for example, private primary or secondary schools and colleges). Check the “yes” box and fill in Schedule B if one of your purposes, whether primary or otherwise, is operating a nonprofit school. (See “Filling Out the Schedules,” below, for instructions on completing Schedule B.)

Line 20: If your nonprofit is setting up a hospital or medical care facility, including a medical research facility (see the definitions in the 1023 instructions), answer “yes” and complete Schedule C. (See “Filling Out the Schedules,” below, for instructions on completing Schedule C.)

Line 21: If you are forming a low-income housing facility or housing for the elderly or handicapped (see the 1023 instructions for definitions of these terms), check “yes” and complete Schedule F. (See “Filling Out the Schedules,” below, for instructions on completing Schedule F.)

Line 22: Refer to the 1023 instructions for definitions of terms before answering this question. If your nonprofit, whether it is a school or otherwise, will provide scholarships or other education or education-related financial aid or assistance to individuals, check “yes” and fill in Schedule H. (See “Filling Out the Schedules,” below, for instructions on completing Schedule H.)

Part IX: Financial Data

All groups should complete the financial data tables in Section A (Statement of Revenues and Expenses) and Section B (Balance Sheet) of this Part IX. Start by reading the 1023 instructions for this part.

The financial data supplied with the 1023 application is used to show that the nonprofit can reasonably be expected to receive support over its first five years that qualifies it for the public charity status it is seeking (you choose a public charity classification in Part X). At the end of the five-year period, the IRS will look at groups' annual Form 990 or 990-EZ returns for the past five years (the current year plus the last four years) to see if the group continues to qualify as a public charity. If the group fails the five-year test for two years, it will lose its public charity status and will be reclassified as a private foundation. See Chapter 10 for more on Form 990s. See the IRS website article, "Advance Ruling Process Elimination-Public Support Test," at www.irs.gov/charities-non-profits/charitable-organizations/advance-ruling-process-elimination-public-support-test, for information on the five-year support test for public charity status.

EXAMPLE: The Free Food Program gets its 501(c)(3) tax exemption and public charity tax status starting in 2013. FFP will be treated as a public charity for the five-year period from 2013 to and through 2017. At the end of 2018, the IRS will look at the group's 2014 through 2018 Form 990 returns to see if it still qualifies as a public charity.

Statement of Revenues and Expenses

The financial data listed here includes your group's past and current receipts and expenses (many groups will need to show proposed receipts and expenses, as explained below). The IRS will use this financial data to make sure that:

- your group's actual and/or proposed receipts and expenses correspond to the exempt-purpose activities and operational information you describe in your application

- you do not plan to engage substantially in unrelated business activities, and
- you do or most likely will meet the appropriate 501(c)(3) public charity support test (see our instructions to Part X, below).

The number of columns you use in Section A will depend on the number of full and partial tax years your group has been in existence. Most nonprofits will have a tax year that goes from January 1 to December 31, but some will have a tax year that ends on the last day of another month—see your response to Part 1, line 5, above.

New groups without prior tax years. If your nonprofit is newly formed, it probably has not been in existence for a full tax year. Put projected numbers for the current year in column (a), and projections for the next two years in columns (b) and (c) for a total of three years.

EXAMPLE: You are a new nonprofit formed on February 15 of the current year, with a tax year that goes from January 1 to December 31, and you are applying for your tax exemption in June of the corporation's first tax year. The beginning "from" date of the period shown at the top of column (a) is the date you filed your articles—February 15 of the current year. The "to" date for this period should be December 31, the end of the current tax year. Use columns (b) and (c) to show projected figures for your next two tax years, going from January 1 to December 31 of each of the next two years. Many new groups will repeat much of the information from their first tax year for the next two proposed tax years, unless they anticipate a major change in operations or sources of support. Use column (e) to show the total for columns (a) through (f).

Don't expect to fill in all the items. The IRS knows you've just commenced operations and that you are estimating possible sources of

revenue and items of expense, and it expects to see a few blank lines. Also realize that some of your projected revenues and expenses may not neatly fit the categories shown in the printed revenue and expense table. You can use revenue item 7 (other income) and expense item 23 (other expenses) to list totals for these items, and attach a list that itemizes these additional items of revenue and expense on an attachment page. The IRS does not like to see large lump sum amounts, so break down these additional items of revenue and expense as much as possible.

Groups with prior tax years. If your nonprofit has been in existence for five or more prior tax years, show actual revenue and expense amounts for your last five completed tax years in columns (a) through (d). Note that you will have to add a column between (d) and (e) for your fifth year—column (e) is for totals for all five years. You can provide this extra column of information on an attachment page (or you can split column (e) in half and use the left side of (e) for your fifth-year data). Note that the current year, column (a), will be your last completed tax year, not the partially completed current tax year. You will be supplying figures for five completed tax years, and no projected information.

Alternatively, if your nonprofit has been in existence more than one full tax year, but less than five tax years, you must show projected financial information for your current tax year in column (a), then show figures for your prior completed tax year(s) in the other column or columns. You also may need to show projected revenue and expense information in one of the columns for a future tax year depending on how many years you have been in existence. Here is how it works:

If your group has been in existence one full prior tax year, show projected figures for the full current tax year in column (a), and your prior completed tax year in column (b). Then show projected figures for the next two years' revenues and expenses (the two tax years after the current tax year) in columns (c) and (d). This information represents four full tax years' worth of information—one completed tax year and three projected tax years.

If your group has been existence two full prior tax years, show projected figures for the full current tax year in column (a), your most recent completed tax year in column (b), and your first completed tax year in column (c). Then show projected figures for the next year's (the year after the current year) revenues and expenses in column (d). This information represents four full tax years' worth of information—two completed tax years and two projected tax years. Use column (e) for totals of the other columns.

Line 12 of the revenue and expense statement asks you to list any “unusual” revenue. This term is explained in the instructions for this line in the 1023 instructions, and we explain it in more detail in “Public Support Test” and “Exempt Activities Support Test,” in Chapter 4, as it applies to the different public charity support tests. Also see the specific rules on unusual grants contained in IRS Publication 557.

Basically, unusual grants are permitted grants which can throw a kink in your public charity support computations because they come from one source, as opposed to several smaller grants from different sources. Remember, 501(c)(3) public support revenue is supposed to be spread out and come from a number of public sources, not just one or two. It is unlikely that you expect to receive an unusual grant this early in your

nonprofit life—unusual grants normally happen only as a result of a sustained and successful outreach program that attracts one or two large grants that surprise the modest expectations of a small nonprofit. In effect, an unusual grant represents both good and bad news. The good news is the unusually large amount of the grant; the bad news is its potential damage to the group’s ability to meet the technical public support requirements that apply to 501(c)(3) public charities. If you have received or expect to receive one or more unusual grants, insert the total number here on line 12 in the appropriate column (past, present, or future tax year), and list on an attachment page a description of each grant (what the grant was for, whether it was restricted to a specific use, and other terms of the grant), together with the donor’s name, date, and amount of each unusual grant. If a large grant qualifies as an unusual grant, it will be disregarded by the IRS when it computes whether your support qualifies under the technical public charity support test rules (see Part X, below).

Balance Sheet

Prepare the balance sheet to show assets and liabilities of your corporation as of your last completed tax year, if any, or the current tax year if you have not yet completed one full tax year.

EXAMPLE: You have organized a new nonprofit corporation, formed on April 1. You are preparing your 1023 application in November of the same year. Your tax year goes from January 1 to December 31. The current tax year period covered by column (a) of your Statement of Revenue and Expenses is from April 1 to December 31. Your balance sheet ending date will be the same ending date, December 31, the eventual ending date of your first tax year. This date should appear as the “year-end” date in

the blank at the top right of the balance sheet page. Even though this is a future end date, you should base your statement of assets and liabilities on current information—that is on your organization’s current assets and liabilities at the time of the preparation of your exemption application.

It’s not uncommon for a small starting nonprofit without liabilities and accounts receivable to simply show a little cash as its only reportable balance sheet item. Other common items reported are line 8 depreciable assets—equipment owned by the corporation and used to conduct its exempt activities.

Line 17 of the balance sheet asks for fund balance or net asset information. Typically, this is the amount by which your assets exceed your liabilities—in other words, the net value of your assets. If you have difficulty preparing the financial information under this part, get the help of a tax or legal adviser.

Line 19 asks if there have been substantial changes in your assets and liabilities since the year-end date for your balance sheet. This question should be answered “no” by most groups. However, if your nonprofit is submitting a balance sheet for a prior completed period and your assets and liabilities have undergone significant change—as a result, perhaps of a sale or purchase of assets, a refinancing of debt, or other major structural change—answer “yes” and provide an explanation on an attachment page.

Part X: Public Charity Status

You should be familiar with the material in Chapter 4 in order to answer the questions in this part of the form. This is where terms such as “public charity” and “private foundation”

become important. We will refer to earlier explanations as we go along, but you may want to look over Chapter 4 now before you proceed. The questions in this part relate to whether you are seeking to be classified as a 501(c)(3) public charity or as a 501(c)(3) private foundation. As you know by now, we assume you want your nonprofit to qualify as a 501(c)(3) public charity, not as a 501(c)(3) private foundation.

Lines 1(a)–(b): In Chapter 4, we discussed the distinction between the public charity and private foundation classifications and the reasons that you should try to meet one of the three primary tests for being classified as a public charity. The 1023 instructions provide a list of groups that qualify for public charity status, which lumps all publicly supported groups together (“groups that have broad financial support”). We use a different classification scheme in Chapter 4, which puts public charities into one of three categories:

- (1) **Automatic Public Charity Status:** groups that are set up for a specific purpose or special function, such as churches, schools, hospitals, and public safety organizations, qualify as public charities (we say they “automatically” qualify because these groups, unlike the other two types of public charities listed below, do not have to meet public support tests).
- (2) **Public Support Test Groups:** these are groups that are supported by contributions and grants and that meet the one-third or one-tenth public support tests described in “Public Support Test” in Chapter 4.
- (3) **Exempt Activities Support Test Groups:** these are groups that obtain support through the performance of their exempt purposes, such as admissions, tuition, seminar fees, and receipts from goods and services related to the group’s exempt purposes.

We assume your nonprofit will either be setting up one of the special public charities that automatically qualify under (1), above, or a nonprofit that has or can reasonably expect to receive the type of support listed in (2) or (3), above.

Line 1(a): Check “yes” or “no” on line 1(a) to indicate whether or not you are a private foundation. Again, we assume you expect to qualify as a public charity and will mark “no” to this question. If your response is “no,” go on to line 5. If you are forming a 501(c)(3) private foundation, check “yes” and go on to line 1(b).

Line 1(b): This line only applies if you answered “yes” to line 1(a). Line 1(b) asks you to check the box as a reminder that your private foundation requires special provisions in your articles or reliance on special provisions of state law. This book and its forms do not address these extra requirements, and you will need the help of a nonprofit adviser to form your 501(c)(3) private foundation and prepare your articles properly.

Lines 2–4: As with line 1(b) above, these lines only apply if you answered “yes” to line 1(a) indicating that you are applying for a tax exemption for a 501(c)(3) private foundation. These questions ask even more specific questions to help pigeonhole the private foundation into special subcategories—private operating and private nonoperating foundation categories. We assume you will get the help of an experienced legal or tax person who works with private foundations before answering these questions. After answering these questions, a group that is preparing its 1023 application for a private foundation should skip the remaining lines in this part of the form and go on to Part XI.

Line 5: Check the box (letters (a)–(j)) that corresponds to the basis of your claim to public charity status. First, absorb what you can of the technical material given in the 1023 line 5

instructions. Then reread “How to Qualify for Public Charity Status,” in Chapter 4—this section provides the names of these public charity organizations, the requirements they must meet, and the Internal Revenue Code sections that apply to them. Note that letter (j) is a special case that allows certain groups to have the IRS determine which public charity support test best suits their activities and sources of revenue. We cover this special choice in more detail in line (j), below.

The following chart shows how the different types of groups listed in this part of the application fit within the three different categories of public charity status discussed in “How to Qualify for Public Charity Status,” in Chapter 4. If you concentrate on our basic division of these different groups into the three public charity categories, rather than focusing on the individual Internal Revenue Code sections, this part will go more smoothly.

Let’s look a little more closely at each of the lettered boxes in line 5:

Line 5(a): If you seek to qualify automatically for public charity status as a church, see the 1023 instructions to this item. You will need to complete Schedule A and include it with your 1023 application. (See “Filling Out the Schedules,” below, for instructions on completing Schedule A.)

Lines 5(b): Check this box if your primary purpose is to set up and operate a formal school. If you check this box, make sure you have completed Schedule B. See the separate 1023 instructions to Schedule B, in “Automatic Public Charity Status,” in Chapter 4 (see the section “Schools”), and our instructions for filling out Schedule B in “Filling Out the Schedules,” below.

If you will set up and operate a school, but operating the school is not your primary purpose, do not check this box—you will need to qualify as a public charity by checking one of the other line 5 boxes. However, you must complete Schedule B and attach it to your

IRS Part X Public Charities Covered in Chapter 4

Line 5(a)	Church	Chapter 4, Automatic Public Charity Status
Line 5(b)	School	Chapter 4, Automatic Public Charity Status
Line 5(c)	Hospital or medical research	Chapter 4, Automatic Public Charity Status
Line 5(d)	Supporting organizations	Chapter 4, Automatic Public Charity Status
Line 5(e)	Public safety organizations	Chapter 4, Automatic Public Charity Status
Line 5(f)	Government organization supporting colleges	Chapter 4, Automatic Public Charity Status
Line 5(h)	Public support test groups	Chapter 4, Public Support Test
Line 5(i)	Exempt activities support test groups	Chapter 4, Exempt Activities Support Test
Line 5(j)	Either public support or exempt activities support test group	Chapter 4, Public Support Test and Exempt Activities Support Test

exemption application if you plan to operate a school, even if operating the school is not your primary purpose and the basis for your claim to public charity status—see the instruction to line 5(b) in the 1023 instructions.

Lines 5(c)–5(g): Read the instructions for these lines in the 1023 instructions. Few groups will choose one of these boxes—each applies to a special type of organization such as a hospital, supporting organization, public safety organization, government agency for the benefit of a college or university, or an agricultural research organization affiliated with a college or university.

Line 5(c) hospitals and medical research groups will need to complete Schedule C—you should refer to the 1023 instructions for this schedule, the section “Hospitals and Medical Research Organizations” in “Automatic Public Charity Status,” in Chapter 4, and our instructions for filling out Schedule C in “Filling Out the Schedules,” below.

Line 5(d) supporting organizations are a special type of nonprofit set up to support other public charities. They are operated solely for the benefit of, or in connection with, any of the other public charity organizations (except one testing for public safety). A supporting organization must complete Schedule D. This information helps the IRS determine whether this type of organization supports other qualified public charities.



TIP

Get help when applying for an exemption for a special type of nonprofit. If you check one of the 5(c) through 5(g) boxes, the lawyer, accountant, or other adviser who is helping you organize one of these special corporations should help you with your application and any additional schedules you have to prepare and include with your application.

Line 5(h): First read the 1023 instructions for this line. This box is for organizations that receive a substantial part of their support from government agencies or from the general public. These are the public support test groups discussed in Chapter 4. If you believe this is the public charity best suited to your organization’s sources of support, check the box on this line. If you are unsure whether this is the best support test to use for your group (that is, if you think that the exempt activities support test in line 5(i) also may apply to your organization), you may wish to let the IRS make this decision for you as explained in the line 5(i) instructions, below.

As discussed in “Public Support Test,” in Chapter 4, many groups will not want to fall under this public charity test because it does not allow your receipts from the performance of services related to the corporation’s exempt purposes to be included as “qualified public support.”

Groups checking line 5(h), go on to Part X, line 6.

Line 5(i): Start by reading the 1023 instructions for this line. This box is for organizations that normally receive one-third of their support from contributions, membership fees, and gross receipts from activities related to the exempt functions of the organization (subject to certain exceptions) but not more than one-third from unrelated trades and businesses or gross investment income. This exempt activities support test is discussed in Chapter 4. This is the most common and often the easiest way to qualify a new nonprofit organization as a public charity. So reread the requirements of this test and the definition of terms associated with it in Chapter 4. If you believe this public charity test best suits your expected sources of support, check this box. If you are unsure, see the instructions to line 5(j), just below.

Groups checking line 5(i), go on to Part X, line 6.

Line 5(j): If you feel that your group may qualify as a public charity either under line 5(h) or 5(i) but aren't sure which to choose, you can check this box. The IRS will decide which of these two public charity classifications best suits your organization based upon the financial data and other financial support information included in your 1023 application. For many new groups, line 5(j) is the best way to go. Rather than working through the math and the technical definitions necessary to approximate whether you will qualify as a public charity under line 5(h) or 5(i), by checking this box you let the IRS do the hard work for you.

Groups checking line 5(j), go on to Part X, line 6.

Here are some sample responses to line 5 by some typical, hypothetical nonprofit groups:

The First Fellowship Church, a religious organization that plans to maintain a space to provide weekly religious services to its congregation, checks line 5(a) to request automatic public charity status as a church.

The Workshop for Social Change, an educational group that plans to receive support from public and private grant funds and from individual and corporate contributions, checks line 5(h) to request public charity status as a publicly supported organization.

Everybody's Dance Studio and Dinner Theater, a group that expects to derive most of its operating revenue from student tuitions, special workshops, and ticket sales (as well as from other exempt purpose activities), selects line 5(i) to be classified as a group that meets the exempt activities support test, discussed in Chapter 4.

The School for Alternative Social Studies, an accredited private postgraduate school with

a formal curriculum, full-time faculty, and regularly enrolled student body, checks line 5(b) to request automatic public charity status as a formal private school.

The Elder Citizens' Collective and Information Exchange, which plans to derive support from contributions and grants as well as subscriptions to its weekly newsletter (and other exempt-purpose services and products made available to members and the public at large), checks line 5(j) to have the IRS decide whether line 5(h) or 5(i) is the appropriate public charity classification.

Line 6: Only groups that have checked line 5(h), 5(i), or 5(j)—groups that are seeking to be classified as publicly supported public charities—should look at line 6. If you checked line 5(h), 5(i), or 5(j), but your nonprofit has not been in existence for more than five years, ignore lines 6(a) and 6(b), and go on to line 7.

Line 6(a): If you checked line 5(h) or 5(j) and your nonprofit has been in existence more than five years, answer the line 6(a) questions as explained in the next several paragraphs.

First read the official 1023 instructions to these items before following our instructions below.

Line 6(a)(i): Enter 2% (0.02) of the amount shown in Part IX-A (Revenues and Expenses), line 8, column (e)—this is 2% of your organization's total public support received over the tax years shown in Part IX-A.

Line 6(a)(ii): If any individual, organization, or company has contributed more than the 2% amount shown in 6(a)(i) during the prior tax years covered in Part IX-A (Revenues and Expenses) of your application, supply the name(s) of the contributor(s) and the amount(s) contributed on an attachment page. Conversely, if no individual, organization, or company contributes more than this 2% amount,

Who Are Disqualified Persons?

People who are disqualified in the eyes of the IRS are not necessarily prohibited from participating in the operation of the 501(c)(3) nonprofit corporation. Instead, their contributions to the nonprofit may not count when figuring the public support received by public charities. (Note that the definitions of disqualified persons discussed here are different from the definitions of disqualified persons under IRC § 4958—see the instructions to Part V, above, for information on this separate set of definitions.) If the corporation is classified as a 501(c)(3) private foundation, the corporation and the disqualified individual can be held liable for certain private foundation excise taxes. Disqualified persons for purposes of meeting the public charity support tests include:

1. Substantial contributors. These are donors who give more than \$5,000, if the amount they contributed is more than 2% of the total contributions and bequests received by the organization. For example, suppose Ms. X makes a gift of \$20,000 to your nonprofit corporation. If this gift exceeds 2% of all contributions and bequests made to your organization from the time it was created until the end of the corporate tax year in which Ms. X made the contribution, Ms. X is a substantial contributor.

For purposes of determining whether a substantial donor is a disqualified person, gifts and bequests made by that individual include all contributions and bequests made by the individual's spouse. Once a person is classified as a substantial contributor, he or she generally remains classified as one (regardless of future contributions made, or not made, by the individual or future support received by the organization). However, if other conditions are met, a person will lose his or her status as a substantial

contributor if he or she makes no contribution to the organization for ten years.

2. All foundation managers. Directors, trustees, and officers (or people with similar powers or responsibilities), or any employee with final authority to act on a matter, are disqualified as foundation managers—this means the bigwigs in a nonprofit who exercise executive control. Officers include persons specifically designated as “officers” in the articles, bylaws, or minutes, and persons who regularly make administrative and policy decisions. Officers do not include independent contractors, such as accountants, lawyers, financial and investment advisers, and managers. Generally, any person who simply makes recommendations for action but cannot implement these recommendations will not qualify as an officer.

3. Owners and substantial players in entities that contribute. An owner of more than 20% of the total combined voting power of a corporation, the profits of a partnership, or the beneficial interest of a trust or an unincorporated enterprise are all disqualified, if any of these entities is a substantial contributor.

4. Family members. A member of the family—including ancestors, spouse, and lineal descendants, such as children and grandchildren, but not brothers and sisters—of any of the individuals described in 1, 2, or 3 above, is disqualified.

5. Other business entities. Corporations, partnerships, trusts, and so on in which the persons described in 1 through 4 above have at least a 35% ownership interest.

For more information on disqualified persons, type “private foundations and disqualified person” in the search box of the IRS website at www.irs.gov.

respond “None.” Why does the IRS want this information? For line 5(h) public support test charities, the IRS generally does not count amounts that exceed 2% of the group’s total support as qualified public support (for more on the 2% rule and its exceptions, see “Public Support Test” in Chapter 4 and IRS Publication 557, “Support From the General Public”).

Line 6(b): If you checked line 5(i) or 5(j) and your nonprofit has been in existence more than five years, answer the line 6(b) questions as explained in the next several paragraphs. First read the official 1023 instructions to these line 6(b) items before following our instructions below.

These questions require you to disclose sources of support that the IRS does not consider qualified public support for groups that are seeking public charity status under the exempt activities support test (the groups covered in “Exempt Activities Support Test” in Chapter 4 that rely on support received primarily from their exempt-purpose activities). We’re talking here about contributions from disqualified persons or gross receipts from other individuals that exceed the larger of 1% of the organization’s total support or \$5,000 in any tax year.

Line 6(b)(i): For a definition of disqualified persons, including a “substantial contributor,” see the official instructions to the form. We provide a somewhat friendlier set of definitions of these terms in “Who Are Disqualified Persons?” above. If a disqualified person provided gifts, grants, or contributions, membership fees, or payments for admissions, or other exempt purpose services or products (these are the categories listed in lines 1, 2, and 9 of Part IX-A, Revenues and Expenses) during any tax year shown in Part IX-A, list the disqualified persons and amounts contributed or paid on an attachment page. If

no disqualified person paid or contributed any of these amounts, respond “None.”

Line 6(b)(ii): If any person (other than a disqualified person) has paid more than the larger of either \$5,000 or 1% of the amount shown in line 9 of Part IX, Revenues and Expenses (admissions or other exempt purpose services or products), during any completed tax year shown in Part IX-A, provide the name of the person or organization who made the payment and the amount of each payment on an attachment page. The list should be broken down year by year. If no individual (other than a disqualified person) made such a payment for any of the completed tax years shown in Part IX-A, respond “None.”

Unusual Grants

Unusual grants are contributions, bequests, or grants that your organization receives because it is publicly supported but that are so large that they could jeopardize your ability to meet your public support test. The benefit of having a large grant qualify as an unusual grant is that it does not jeopardize the group’s public charity status (as do other large sums received from a single source). It is unlikely that your beginning nonprofit has received sums that should be classified as unusual grants. For further information on this technical area, see the 1023 instructions to line 7 of Part X, the discussion and examples of unusual grants in “What Is Public Support?” in Chapter 4 (see “Money From Unusual Grants” and “Unusual Grants Drop Out of the Support Computation”), and the specific rules on unusual grants contained in IRS Publication 557.

Line 7: To answer this question, first refer to our instructions to Part IX-A above (Statement of Revenue and Expenses). If you have listed any unusual grants on line 12 of the Statement of Revenue and Expenses in any of the columns, check “yes” and list them on an attachment page along with the donor’s name, date, and amount and the nature of the grant (what the grant was for, whether it was restricted to a specific use, and other terms of the grant that make it unusual). If you provided this information in an attachment to Part IX-A, you can refer to your earlier response. For further explanation of what constitutes unusual grants, see “Unusual Grants,” below. If you have not listed any unusual grants in the Part IX-A Revenue and Expense statement, check the “no” box.

Part XI: User Fee Information and Signature

You must pay a user fee when you submit your 1023 tax exemption application. The fee is \$600 for a Form 1023 application (the fee for the online 1023-EZ filing is \$275—see “Ways to Complete the Tax Exemption Application,” above).



CAUTION

Always check that the fee amount is current.

Your user fee check should be made payable to the “United States Treasury” and show “User fee Form 1023 [name of your group]” on the check memo line. Before writing your check, go to the IRS website at www.irs.gov to make sure you have the current fee amounts. Type “Exempt Organizations User Fee” in the keyword box to find fee amounts. Alternatively, call the IRS Exempt Organization Customer Service telephone number at 877-829-5500 to ask for current 1023 user fee amounts.

Signature, Name, Title, and Date Lines: Have one of your initial directors or officers sign, type his or her name and title (director, president,

chief operations officer, or the like), and insert the date on the lines provided at the bottom of Part XI.

Write a check payable to the United States Treasury for the amount of the user fee. *Do not staple* or otherwise attach your check to your application. Simply place your check at the top of your assembled exemption application package, as explained in the next section. The check does not have to be an organizational check. The person preparing the application or any other incorporator may write a personal check. The user fee is kept by the IRS in almost all circumstances, even if your application is denied. The only time it is refunded is if the IRS decides that it cannot issue a determination as to your exempt status one way or the other—because it has insufficient information or cannot resolve some of the issues associated with your tax exemption request. By the way, this rarely happens. For example, if you don’t respond to any follow-up questions that the IRS may ask in response to your application, it normally denies your exemption (and keeps the check).

Whew! You’re just about done. Follow the instructions below for assembling your entire federal exemption package.

Filling Out the Schedules

Certain groups must complete and submit schedules with their Form 1023 application. In the line-by-line instructions to the 1023 form, above, we let you know when you are required to complete a schedule. For example, in Part VII, line 1, of the application, we tell you that if you answered “yes” to that item, you must complete Schedule G. If you do not need to submit any schedules with your Form 1023, you can skip this section.

Schedule A. Churches

See the separate instructions to Schedule A, included in the last portion of the official 1023 instructions, for help in filling out this schedule. We've discussed the requirements for churches in "Automatic Public Charity Status," in Chapter 4. The questions here seek to determine whether your organization possesses conventional institutional church attributes—the more the better as far as the IRS is concerned.

Schedule B. Schools, Colleges, and Universities

See the official 1023 instructions to Schedule B for help in completing this schedule. Your responses to this schedule should show that your operations are nondiscriminatory and in accordance with a nondiscrimination statement included in your bylaws and published in the community in which you serve (you must attach this bylaw resolution to Schedule B). For information on drafting and publishing this statement of nondiscrimination, see "Educational Purposes" in Chapter 3. Also see IRS Publication 557, under "Private Schools" (available on the Nolo website; see Appendix A for the link).

Schedule C. Hospitals and Medical Research Organizations

Make sure to check the appropriate box at the top of the schedule and fill out the appropriate section of the form. Generally this schedule seeks to determine two things:

- whether the hospital is charitable in nature and qualifies for 501(c)(3) tax-exempt status, and

- whether the hospital or medical research organization qualifies for automatic public charity status (see the Schedule C instructions in the official 1023 instructions and IRS Publication 557, under "Hospitals and Medical Research Organizations").

A 501(c)(3) charitable hospital normally has many of the following characteristics:

- staff doctors selected from the community at large
- a community-oriented board of directors (directors come from the community served by the hospital)
- emergency room facilities open to the public
- a policy of allowing at least some patients to be treated without charge (on a charity basis)
- a nondiscrimination policy with respect to patient admissions (it doesn't pick and choose its patient population) and particularly does not discriminate against Medicare or Medicaid patients, and
- a medical training and research program that benefits the community.

Hospitals need to be careful when it comes to renting space to physicians who are members of the board—and carrying out a private practice that's unrelated to the community service programs of the hospital. The IRS will be particularly suspicious if such physicians are prior tenants and their rent is below fair market value. Section 1, question 7, of Schedule C addresses this issue.

Hospitals should adopt a suitable conflict of interest policy in their bylaws (see Schedule C, Section 1, line 14). Article 9 of the bylaws included with this book contains most of the provisions in the sample conflict of interest

policy provided in Appendix A of the official 1023 instructions. However, it does not include the special bracketed provisions that apply specifically to hospitals. There are two, which are clearly marked in Appendix A of the 1023 instructions with the words “[Hospital Insert—for hospitals that complete Schedule C ...].” Make sure you insert these additional bracketed provisions to the provisions in Article 9 of the bylaws included with this book.

The Affordable Care Act (ACA) added new requirements for charitable hospitals. (See Notice 2010-39 and Notice 2011-52 and ask your tax adviser for more information.)

Schedule D. Section 509(a)(3) Supporting Organizations

Refer to the 1023 instructions for this schedule, Chapter 4, “Automatic Public Charity Status (see “Supporting Organizations”) and Publication 557, under “Section 509(a)(3) Organizations.” This is a complicated schedule—you must meet a number of technical tests. Your nonprofit legal or tax adviser can help you qualify for this special type of public charity classification.

Schedule E. Organizations Not Filing Form 1023 Within 27 Months of Formation

Before filling in Schedule E, read the official IRS 1023 instructions to Schedule E, which are contained in the instructions for separate schedules at the end of the 1023 instructions. This material will give you some basic definitions and information that will help you work your way through the schedule.

Lines 1–3: Three groups are not required to file Form 1023: churches; public charities that normally have gross receipts of not more than \$5,000 in each year (see the extra instructions for

line 2(a)-2(b) below); and subordinate organizations exempt under a group exemption letter (see Section B, above). If you decide that you fall within one of these exceptions (after reading any additional instructions for the line below), check the “yes” box or boxes on the appropriate line (either line 1, 2, or 3) and go on to Part VIII of the 1023 form. You do not need to complete the rest of Schedule E. If the IRS agrees that you qualify as one of these three special groups, your federal exemption will be effective retroactively from the date of your incorporation, even though you filed your exemption application late (after more than 27 months from the end of the month when you filed your articles).

If you fall within one of the three groups, you are filing an exemption application even though you believe you are not required to do so and even though you are filing more than 27 months after your nonprofit corporation was formed. As we said in Section B, above, we agree that this is the best way to go because by submitting your exemption application you are making sure the IRS agrees that your group is entitled to a tax exemption in one of these three special 501(c)(3) categories.

Lines 2(a)–2(b): The 2(a) exception is often applicable to new nonprofits. Your group qualifies if it:

- is a public charity rather than a private foundation (because one of the purposes of completing your 1023 application is to establish that you are eligible for public charity status, we assume that you meet this requirement), and
- “normally” has gross receipts of not more than \$5,000 in each tax year.

Groups that have been in existence for two tax years qualify if they had total gross receipts of \$12,000 or less during the first two years. We assume your group has been in existence for at

least two years because it is filing more than 27 months after it was formed. If you have been in existence for three or more tax years, your gross receipts over the three years must be \$15,000 or less to qualify for the “normally \$5,000” exception. Many new groups without outside sources of support can meet this gross receipts test during their beginning tax years. And, if you can’t check “yes” to line 2(a), there’s a technical loophole in line 2(b): It says that groups that are filing their 1023 application within 90 days after the end of the tax year when they qualified for the “normally \$5,000 gross receipts” test also can file their application late.

EXAMPLE: You form a new nonprofit corporation in January of 2014 and file your tax exemption application more than four years later—in February 2018. Your group had gross receipts of less than \$5,000 for 2013 through 2016, but 2017 was a really good year so the total gross receipts for your organization over the three-tax-year period from January 2015 through December 2017 was \$25,000. This is well over the three-year \$15,000 cumulative total maximum amount. If you submit your 1023 application in February of 2018, which is within 90 days of the end of 2017, you can check box 2(b) and have the tax exemption extend all the way back to the date of incorporation because it meets this special line 2(b) exception. Obviously, this 2(b) exception is intended for groups that file quickly after determining that their past three-year cumulative gross receipts put them over the \$15,000 mark. Once they go over this mark, they become a group that is required to file a 1023 application—the IRS will let them have their tax exemption for all prior years, even though the last three-year cumulative total exceeded the \$15,000 threshold, as long as the group files the Form 1023 within 90 days of the end of the high-receipts tax year.

Line 4: Here is where you end up if your group is filing the 1023 application more than 27 months from the date of your incorporation and you don’t meet one of the three exceptions listed in lines 1 through 3 of this part. Groups formed on or before October 9, 1969 get a special break. Of course, we assume you were formed recently, and will check “no” and move on to line 5.

Line 5: Since your group is not one of the special groups listed in the previous lines on Schedule E, your group can only qualify for an exemption that extends back to its date of formation if it asks the IRS to qualify for late filing. To do this, check “yes” and attach a statement giving the reasons why you failed to complete the 1023 application process within the 27-month period after your incorporation. (after reading the 1023 instructions for this line). Federal rules, contained in Treasury Regulations 301.9100-1 and 301.9100-3, also include a list of the acceptable reasons for late filing, as well as those that aren’t. For example, acceptable reasons include the following: you relied on the advice of a lawyer, accountant, or an IRS employee, and received inaccurate information or were not informed of the deadline. These acceptable reasons are summarized in the 1023 instructions for this line. After attaching your statement, perhaps with the help of your tax adviser, go on to Part VIII of the 1023 application—you should not complete the rest of Schedule E.

If you don’t think you can qualify for an extension (or if you decide not to bother—see “If You End Up on Schedule E, Line 5, Should You Ask for an Extension?” below), check “no” and go on to line 6.

If You End Up on Schedule E, Line 5, Should You Ask for an Extension?

Most groups will not end up on Schedule E, line 5—they will submit their 1023 application within 27 months from the date of their incorporation. If your group does end up here, you may decide not to bother seeking an extension and simply check “no” on line 5. This means that your 501(c)(3) exemption, if granted, will be effective only from the application’s postmark date, not from the date of your incorporation. Is this so terrible? Often, it isn’t. Here’s why. Many nonprofits will not have any taxable income or contributions from donors during these early start-up months (the 27-plus months of operation prior to filing their 1023 application). Consequently, obtaining a tax exemption for these early months will not provide a tax benefit. However, if your group is facing tax liability for early operations, the need to provide donors with tax deductions for gifts contributed during the first 27-plus months, or the need to obtain 501(c)(3) tax-exempt status from the date of its creation for some other pressing reason, then it makes sense to prepare a special statement under line 5 as explained in the text. If you are unsure, check with your tax adviser.

Line 6(a): If you checked “no” on line 5 (you don’t want to qualify for an extension of time to file), you should check “yes” to 6(a) and move on to 6(b). This means that you agree that your 501(c)(3) exemption can be recognized only from its postmark date, not retroactively to the date of your incorporation.

Note: We’re not sure what happens if you end up by clicking “No” to 6(a). Does this mean that you are submitting an exemption application

late but you understand that it will be denied (or that you may be granted an exemption but your public charity status will be denied and you will be classified as a tax-exempt private foundation, a classification you definitely will NOT want)? If you end up at 6(a) but do not plan on checking “Yes” or have any questions about how to respond, please check with a tax or legal specialist to help you with your application.

Line 6(b): Most groups that are applying late for their tax exemption and ended up at line 6(a) are not planning to substantially change how they get financial support, so they will check “no” to 6(b) and ignore the table in line 7—they will move on to line 8 of Schedule E. However, some groups that are applying late realize that their past operations and sources of financial support may or may not qualify them to meet one of the public charity support tests (as more fully explained in our instructions to Part X), and will want to change their plans for financial support now. If this is the case for your late-filing nonprofit, mark “yes” to 6(b), then fill in the projected revenue table in line 7 to show your expected sources of future financial support.

Line 7: If you marked “yes” to line 6(b), fill in projected sources of financial support for the next two full years following the current tax year. For example, if you are applying for your tax exemption late in July of 2018, and your nonprofit’s tax year goes from January to December (the typical case), supply financial figures for the period from January 2019 to December 2020 in the table. You don’t have to fill in items for all rows, but you should be able to supply figures that show that you expect your nonprofit to obtain support from sources that qualify it for public charity status under one of the two basic financial support categories discussed in Part X.

501(c)(4) Organizations

Internal Revenue Code Section 501(c)(4) provides a federal corporate income tax exemption for nonprofit social welfare groups and civic leagues (see IRS Publication 557, Chapter 4, *Other Section 501(c) Organizations*). Since the promotion of public welfare is defined as “promoting the common good and general welfare of the people of the community,” many 501(c)(3) nonprofits also qualify as 501(c)(4) social welfare organizations. Although 501(c)(4) nonprofits are exempt from federal corporate income taxation, they are not eligible to receive tax-deductible contributions from donors. They also do not enjoy many of the other advantages associated with 501(c)(3) tax-exempt status, such as eligibility to receive public and private grant funds, participate in local, state, and federal nonprofit programs, obtain county real and personal property tax exemptions, and other benefits.

But 501(c)(4) organizations do enjoy one advantage not available to 501(c)(3) groups: They may engage in substantial legislative activities and may support or oppose candidates to public office. For further information on 501(c)(4) tax-exempt status, see IRS Publication 557.

Schedule F. Homes for the Elderly or Handicapped and Low-Income Housing

See the 1023 instructions for help in filling out this schedule. In part, this schedule attempts to determine whether elderly or handicapped housing facilities are made available to members of the public or the particular community at reasonable rates, whether provision is made

for indigent residents, whether health care arrangements are adequate, and whether facilities are adequate to house a sufficient number of residents.

Schedule G. Successors to Other Organizations

Line 1(a): We assume your nonprofit is not a successor to a prior profit-making company, which is one such as a sole proprietorship, partnership, limited liability company, or a business corporation that allows its owners to have a proprietary (financial) interest in its assets. In the unlikely case that you check “yes” to line 1(a) because you are a successor to a profit organization, we think you will need help from a nonprofit expert when filing out Schedule G and the rest of your tax exemption application to explain to the IRS why you decided to convert a prior profit-making activity to nonprofit corporate status, and why the new nonprofit is entitled to its tax exemption.

Successor groups that check “no” to line 1(a) will have to check “yes” to line 2(a) to indicate that they are successors to a nonprofit group (remember, a successor group is one that meets one of the successor tests listed in Part VII, Line 1, above—if you are not a successor group, you shouldn’t be filling in Schedule G). Even these groups may need help responding to Schedule G. For example, it asks for the prior tax status and EIN of your predecessor group, and whether it has previously applied for a tax exemption. If the predecessor group was required to file tax returns and/or pay taxes but did not, expect the IRS to ask for these returns (and late filing and late payment penalties too). If the prior group was denied a tax exemption, you will need to clearly explain what has changed that makes you believe you qualify for an exemption now. The schedule also attempts

to determine if the new nonprofit has been set up to benefit or serve the private interests of the people associated with the predecessor organization. If assets were transferred from the prior nonprofit association to the new nonprofit corporation, you are asked to provide a sales or transfer agreement (Schedule G, line 6(c)). If you have prepared this formal paperwork, attach a copy to your application. If you haven't (this is normally the case for small nonprofits that are formally converting a prior nonprofit association to a nonprofit corporation), you should prepare (perhaps with help from someone with financial savvy associated with your nonprofit) and put together a simple term sheet that lists the assets and liabilities transferred to the new nonprofit and the terms of the transfer. This simple agreement should be signed by officers of the prior association and directors or officers of your new nonprofit and attached to Schedule G.

If your nonprofit corporation will lease property or equipment previously owned or used by the predecessor organization or will lease property from people associated with the prior group, include an explanation and copies of any leases as requested in line 8. The IRS will scrutinize a lease to make sure that it does not provide for excessive rent payments to the people associated with the former organization. If a nonprofit corporation is a successor to a prior nonprofit association, it's usually best, if possible, for the prior association simply to assign any leases to the nonprofit corporation without payment (or for a \$1 consideration to keep things legal) or have the corporation renegotiate the leases with the landlord. That way, the successor nonprofit corporation can deal with the landlord directly rather than have people from the former organization retain the lease and require rent payments from the successor nonprofit corporation. (For an

example of an assignment of lease form, see "Prepare Assignments of Leases and Deeds" in Chapter 9.) If your successor nonprofit will lease property back to the people associated with the prior group, line 9 also asks for a copy of the lease agreement. Obviously, a leaseback of property will be strictly scrutinized by the IRS to see if the payments are reasonable—the IRS also will wonder why the new nonprofit transferred the assets in the first place, since after the transfer it decided to lease them back to the people associated with the prior group. Leaseback deals like this look fine in the normal business world, but raise IRS examiner eyebrows when they are disclosed on tax-exemption applications.

Schedule H. Organizations Providing Scholarships, Educational Loans, or Other Educational Grants

Schedule H is used by the IRS to determine whether your nonprofit will provide financial aid on a nondiscriminatory basis. The IRS wants to know that financial aid funds will not be set aside specifically to help put family and friends of people associated with your nonprofit through school and that the providing of funds in general will promote your group's tax-exempt public purposes, which typically will be charitable and/or educational. For further information on IRS guidelines, see IRS Publication 557, under "Charitable Organization Supporting Education" and "Organization Providing Loans." Section II of this schedule can be used to get IRS approval of an organization's grant-making procedures if it is expecting to be classified as a private foundation (not as a public charity). If you are forming a private foundation, consult your tax adviser to help you select the appropriate IRC section on line 1(b) of Section II.

Assemble and Mail Your Application to the IRS

You've accomplished the most difficult part of your paperwork. The only task left is to gather up your application forms and papers and send them off to the IRS. Follow these steps:

Complete the checklist. The IRS wants you to complete and include the checklist with your mailed materials. The checklist is included as the last two pages of the 1023 application form. To complete the checklist, check each box to show you completed all the checklist tasks. If you followed the previous steps in this chapter, you should be able to check each box and complete each checklist task as follows:

- **Assemble your application materials.** Put your materials together in the order shown in the checklist. Note that Forms 2848 and 8821, as well as amendments to articles of incorporation, nondiscriminatory school statement, and Form 5768, will not apply to most groups.
- **User fee.** Place your user fee check at the top of your materials. Do not staple it to your application papers.
- **EIN.** Make sure you have obtained an Employer Identification Number (it should be stated in Part I, line 4, of your application).
- **Completed Parts I through XI of your application.** We assume you can check this checklist box to show you have completed all parts of the 1023 form.
- **Schedules.** Check “yes” or “no” to show which, if any, schedules you have completed and included with your application. Many groups will mark “no” to all schedules. Only submit schedules with your application that

you have completed—do not include blank schedules.

- **Articles.** We assume you have included a file-stamped or certified copy of your articles in response to Part II, line 1, of the application. Fill in the two blanks here to show (1) your purpose clause (repeat the reference to your articles you inserted in response to Part III, line 1) and (2) your dissolution clause (repeat the reference to your articles you inserted in response to Part III, line 2(b)—we assume you did not refer to a state law provision in line 2(c)—see our instructions to Part II above).
- **Signature.** Make sure a director or officer has signed, filled in the name and title lines, and dated the form at the bottom of Part XI.
- **Name of organization.** The name you insert in Part I, line 1, of the 1023 application must be the same as the name of your corporation in your articles of incorporation.

Make copies. After completing the checklist and including it as the first page of your exemption materials, make at least one photocopy of all pages and attachments to your application and file them in your corporate records book.

Mail your application. Mail your package to the IRS address listed in the checklist. You may want to send it certified mail, return receipt requested, to obtain proof of mailing and/or of receipt by the IRS. You can check for the current mailing address on the IRS website, at www.irs.gov. At this writing, the address is:

Internal Revenue Service
Attention: EO Determination Letters
Stop 31
P.O. Box 12192
Covington, KY 41012-0192