

# CRS Report for Congress

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## **Characteristics of and Reporting Requirements for Selected Tax-Exempt Organizations**

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# Characteristics of and Reporting Requirements For Selected Tax-Exempt Organizations

## **Summary**

This report addresses in summary fashion the differences among several kinds of tax-exempt organizations described in Internal Revenue Code [IRC] subsections 501(c)(3), 501(c)(4), 501(c)(5), 501(c)(6), and section 527. Each of these types of organization has a unique statutory definition, is subject to certain statutory limitations on its activities, enjoys certain benefits from obtaining tax-exempt status, and must share certain information with the general public. Following the report is a table which summarizes this information.

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# Characteristics of and Reporting Requirements For Selected Tax-Exempt Organizations

The term tax-exempt organization encompasses more than 30 types of organizations described in the Internal Revenue Code. By far the largest number of tax-exempt organizations are grouped under five particular categories, and they are usually referred to by their section or subsection of the Code, i.e., 501(c)(3), 501(c)(4), 501(c)(5), 501(c)(6), and section 527. This report was developed to answer frequently asked questions about the differences among these types of organizations: how they obtain exempt status; what they can and cannot do; and what kind of information about them is publicly available.

## Organizational Definitions

**IRC § 501(c)(3).** IRC § 501(c)(3) organizations are sometimes referred to as “charitable” organizations. Typical examples of 501(c)(3) organizations include the Red Cross, churches, schools, hospitals, Boy Scouts, Girl Scouts, animal shelters, and the Little League. They are described as

“organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition . . . or for the prevention of cruelty to children or animals . . . no substantial part of the activities of which is . . . attempting to influence legislation . . . and which does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of (or in opposition to) any candidate for public office.”

These organizations are permitted to engage in an insubstantial amount of lobbying, but they are prohibited from engaging in political campaign activities. Taking positions on issues is considered lobbying, not political campaign activities.

**IRC § 501(c)(4).** IRC § 501(c)(4) organizations are generally referred to as “civic leagues” or “social welfare organizations.” These organizations often engage in activities similar to 501(c)(3) organization activities, but they often try to achieve their goals through influencing legislation, litigating, or inciting the public to political action. There is no tax code prohibition on their lobbying or engaging in campaign activities, but their principal purpose cannot be lobbying or campaigning. Those activities must be in support of their exempt purpose. IRC § 501(c)(4) organizations are

“Civic leagues or organizations not organized for profit but operated exclusively for the promotion of social welfare, or local associations of employees, . . . the net earnings of which are devoted exclusively to charitable, educational, or recreational purposes.”

Examples of 501(c)(4) organizations include the Sierra Club and the American Civil Liberties Union.

**IRC § 501(c)(5).** IRC § 501(c)(5) organizations are described as “labor, agricultural, or horticultural organizations.” Most of these organizations are labor unions. There is no tax code prohibition on their lobbying or engaging in campaign activities, but federal election laws generally require campaign activities to be conducted in a political action committee.

**IRC § 501(c)(6).** IRC § 501(c)(6) organizations are generally thought of as trade associations. There is no tax code prohibition on their lobbying or engaging in campaign activities, but federal election laws generally require campaign activities to be conducted in a political action committee. The Internal Revenue Code describes these types of organizations as

“Business leagues, chambers of commerce, real estate boards, boards of trade, or professional football leagues . . . not organized for profit and no part of the net earnings of which inures to the benefit of any private shareholder or individual.”

Examples of 501(c)(6) organizations include the Chamber of Commerce, Jaycees, American Bar Association, American Medical Association, and the National Association of Manufacturers.

**IRC § 527.** IRC § 527 organizations are political organizations or funds “organized and operated primarily for the purpose of directly or indirectly accepting contributions or making expenditures, or both, for an exempt function.” An *exempt function*<sup>1</sup> means

“influencing or attempting to influence the selection, nomination, election, or appointment of any individual to any Federal, State, or local public office or office in a political organization, or the election of Presidential or Vice-Presidential electors, whether or not such individual or electors are selected, nominated, elected, or appointed.”

IRC § 527 encompasses every kind of political committee from a candidate committee, to a political party, to a political action committee set up by a union, a corporation, or a group of politically-interested citizens. In recent years, “527” has been used to describe certain issue advocacy groups which intend to influence elections by

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<sup>1</sup>In the remainder of this report, when *exempt function* is italicized, it is to emphasize the fact that the term refers to political organization exempt function activities, i.e., influencing or attempting to influence an election, etc., and not activities of other tax-exempt organizations.

advertising about certain political issues; however, the tax definition of 527 organization is not limited to advocacy organizations.

It should be noted that it is not unusual for different types of exempt organizations to form affiliates or related organizations to more effectively perform their missions. For example, labor unions often have a related 501(c)(3) scholarship fund, to which tax-deductible contributions may be made, and a 527 political action committee, which can conduct campaign/endorsement activities which the union cannot legally carry on inside the union itself. Similarly, a trade association might have a lobbying affiliate, a charitable affiliate, and a political action committee. As long as the entities carefully observe the requirements to be a separate organization, these types of relationships are not prohibited.

## Meaning and Benefits of Tax-Exempt Status

**Deductible contributions and dues.** Only 501(c)(3) charitable organizations are eligible to receive *tax-deductible* charitable contributions. Dues to many trade associations [501(c)(6) organizations] and labor unions [501(c)(5)] and some charitable [501(c)(3)] or social welfare organizations [501(c)(4)] may be tax-deductible business expenses for some or all of their members. A portion of the dues paid to non-charitable organization may be non-deductible because of lobbying activities of the organization.

**Tax exemption.** Whether or not they can receive tax-deductible contributions or dues, most exempt organizations, including 501(c)(3)s, 501(c)(4)s, 501(c)(5)s, and 501(c)(6)s, are exempt from tax on all their income unless they have engaged in certain business activities or certain activities which are subject to penalty taxes. Most of the penalty taxes are aimed at 501(c)(3) organizations. There are taxes for excess lobbying and excess political activities and excess personal benefit transactions. If they have employees, exempt organizations pay the usual employer share of taxes for social security and medicare, and they withhold income taxes.

Political organizations [527 organizations] are not exempt from tax on all their income. Political organizations are taxed if they have income which is derived from non-*exempt function* activities, essentially investment income, or if they spend money on non-*exempt function* activities. If they only have *exempt function* income and engage only in *exempt function* activities, they pay no income taxes. Section 527 *exempt function* income is not taxed if conducted by a 527 organization or fund, but is subject to tax if the *exempt function* is conducted by another form of exempt organization.

**Restrictions on lobbying.** In addition to the organizational restrictions on lobbying placed on charitable organizations, IRC § 162(e) restricts the use of tax-deductible dues for lobbying purposes. If a tax-exempt organization collects tax-deductible dues from its members (e.g., a trade association, a labor union, or, possibly, some charitable or social welfare organizations) and engages in lobbying, the organization is required to notify its members of the portion of dues that is nondeductible. That portion is determined by comparing the organization's expenditures on all activities with the percentage of expenditures for lobbying

activities. If the organization chooses not to notify its members or fails to notify its members of the portion of dues which is nondeductible, the organization will pay a proxy tax on its lobbying expenditures. IRC § 6033(e)(2). Organizations whose dues are generally nondeductible are not subject to these requirements.

Section 18 of the Lobbying Disclosure Act of 1995, P.L. 104-65, prohibited organizations described in IRC § 501(c)(4) from receiving federal grants, loans, contracts, or other awards if they engage in lobbying activities, even if they conducted the lobbying with their own funds. This language was amended by P.L. 104-99 to permit lobbying by certain tax-exempt organizations that received federal contracts, but not grants or loans.

The Lobbying Disclosure Act also imposes registration and disclosure requirements on organizations that have paid lobbyists whose lobbying activities on behalf of the organization exceed certain time and monetary limits. For more information on this topic, see CRS Report 96-809A, *Lobbying Regulations on Non-Profit Organizations*, by Jack H. Maskell.

**Restrictions on political activities.** In addition to the organizational restrictions on political campaign activities, IRC § 527(f) provides that *any* 501(c) organization which is not a 527 political organization and which makes expenditures for an *exempt function* is subject to tax on the lesser of its net investment income or the amount spent on an *exempt function*. The tax rate is the highest corporate tax rate with an allowance for capital gains, if any. This provision provides an inducement for exempt organizations with substantial investment income to conduct their campaign and other political activities in 527 organizations or funds.

Although the **tax laws** may permit organizations described in IRC §§ 501(c)(4) social welfare organizations, 501(c)(5) labor unions, and 501(c)(6) trade associations to engage in political campaign activities, providing that such activities are not the organization's primary means of accomplishing its exempt purposes, it should be noted that the **election laws** ban corporations and labor unions from making any contribution or expenditure in connection with federal elections. 2 U.S.C. § 441b. This ban applies whether or not a corporation is for-profit or tax-exempt. Exceptions may arise from the definitions used in election law rules, but it is important to observe that the election law rules do not necessarily correspond to the tax law rules. This is another inducement to conduct these activities in a 527 organization.

## Requirements for Obtaining Exempt Status

Before any organization can apply for exempt status from the Internal Revenue Service, it must be established under state law as whatever type of organization it intends to be, usually a nonprofit corporation, and it must obtain an employer identification number [EIN] from the IRS. This process will generally include developing articles of incorporation and bylaws. Once that has been done, the organization can apply to the IRS for tax-exempt status.

**IRC § 501(c)(3).** These organizations will file IRS Package 1023 within the first 15 months of the organization's life. This assures that the recognition of exempt

status will date back to the date of the formation of the organization. Although there are certain exceptions, generally, if the application is filed at a later time, the determination will date back only to the date of the application.<sup>2</sup> Churches, very small organizations, and organizations which are essentially subsidiaries of organizations which have a “group exemption letter” are not subject to these requirements.

**IRC § 501(c)(4), (c)(5), (c)(6) and (c)(7).** These types of organizations must file IRS Package 1024, filling out the particular sections relevant to their organizational type. There is no particular deadline for filing. For these types of exempt organizations, the recognition of exempt status will date back to the date of formation of the organization providing that the organization’s activities and purposes have not changed over time. If the organization has altered its activities or substantially amended its charter to qualify for exempt status, then the recognition of exempt status will be effective as of a date determined by the Internal Revenue Service.

**IRC § 527.** Political organizations notify either the Federal Election Commission or the Internal Revenue Service of their formation. Political committees required to notify the FEC must do so within 10 days of their formation. Those required to notify the IRS must do so within 24 hours of their formation, using the IRS web site and Form 8871. The penalty for failure to register with the IRS is that the organization will be taxed at the maximum corporate tax rate on all gross receipts (less certain expenses) for the period of the failure.

## Reporting Requirements

IRC § 6033 requires every organization exempt under IRC § 501, with gross income in excess of \$25,000, with certain exceptions mainly for churches and religious organizations, to file an annual return (Form 990). The return is to include items of gross income, receipts, and disbursements, and such information as the Secretary may require by regulations or by forms. IRC § 6033(b) adds a list of specific information which is required to be furnished by IRC § 501(c)(3) organizations, including

- ! total contributions and gifts and the names and addresses of all substantial contributors (gifts in excess of \$5,000);
- ! for 501(c)(3) organizations which have elected a numerical measurement of the substantiality of their lobbying expenditures: their lobbying expenditures, the permissible amount of their lobbying expenditures, their grassroots lobbying expenditures, and the permissible amount of grassroots lobbying expenditures;
- ! information about transfers to and relationships with other 501(c) or 527 organizations in order to prevent diversion of funds from the organization’s exempt purpose or misallocation of revenues or expenses; and

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<sup>2</sup>IRC § 508(a).



- ! any taxes imposed on the organization or organization manager for excess expenditures to influence legislation, certain excess lobbying expenditures, certain political expenditures, or certain excess benefit transactions (i.e., transactions where certain insiders realize unwarranted benefits from their relationship with the exempt organization).

IRC § 6033(f) requires IRC § 501(c)(4) organizations to furnish the information listed above relating to excess benefit transactions, the taxes paid in connection with such transactions, and the persons involved those transactions.

Under prior law, 527 organizations with taxable income over \$100 were required to file Form 1120-POL. Public Law 106-230 retained this requirement and, in addition, required 527 organizations with gross receipts of \$25,000 or more to file Form 1120-POL plus an annual information return [Form 990] with the IRS for taxable years *beginning* after June 30, 2000. Under prior law, tax-exempt organizations with gross receipts of \$25,000 or more filed an annual information return [Form 990] with the IRS, but 527 organizations were not required to do so. The new law brings 527 organizations with gross receipts of at least \$25,000 per year under the annual information return requirement. In addition to the information that other exempt organizations supply, 527 organizations will be required to publicly disclose information about their substantial contributors.

Form 1120-POL is due on the 15<sup>th</sup> day of the *third* month following the close of the taxable year. For a calendar year organization with over \$100 of taxable income, Form 1120-POL is due March 15. This is not a change from prior law. For those 527 organizations required by P.L. 106-230 to file Form 1120-POL because they have gross receipts of \$25,000, but which do not meet the taxable income requirement, the first Form 1120-POL would be due on March 15, 2002, for calendar year organizations. For fiscal year organizations with a fiscal year beginning July 1, the first Form 1120-POL (assuming no taxable income) would be due September 15, 2001.

Form 990 is due on the 15<sup>th</sup> day of the *fifth* month after the close of the taxable year. For calendar year 527 organizations, the first Form 990 will be due on May 15, 2002. For fiscal year 527 organizations, the first Form 990 will be due on the 15<sup>th</sup> day of the *fifth* month after the close of the taxable year. For those whose taxable years began July 1, 2000 and close June 30, 2001, the first Form 990 would be due on November 15, 2001.

All exempt organizations described in IRC § 501(c) which conduct business activities which are unrelated to their exempt purposes have to file a Form 990-T. The regular corporate income tax, with certain adjustments, is imposed on these activities. IRC § 511-514.

All exempt organizations which have employees are required to file the usual employment related tax returns related to income tax withholding, social security and medicare taxes [Form 941], and income reporting [W-2, W-3, Form 1099], and, in many instances, unemployment tax reporting [Form 940].

## Public Disclosure of Returns

IRC § 6104 permits public disclosure of returns filed by organizations exempt under 501(c) and (d). All 501(c) and (d) organizations are required to keep and make available for public inspection during regular business hours a copy of their three most recent annual returns and any materials relating to their applications for exempt status. If an individual makes a request in person to inspect the returns or application, an inspection copy must be provided immediately. If the request is made in writing, the organization must respond within 30 days. The organization is permitted to charge for copying and mailing. If the organization has made its documents widely available, e.g. published them on a web site, it is not required to respond to individual requests for inspection. Although exempt organizations disclose the names of their substantial contributors to the IRS, they are not required to disclose the names and addresses of contributors to the general public. IRC § 6104(d)(3).

Once they begin filing Form 990, political organizations will be subject to these public disclosure requirements. Unlike other exempt organizations, political organizations will be required to disclose the names and address of their substantial contributors.

The penalty imposed on an organization for failing to file the annual information return or failing to include the correct information on the return is \$20 per day for each day the return is not filed, up to the lesser of \$10,000 or 5 percent of the organization's gross receipts for the year. For organizations with gross receipts over \$1,000,000, the daily penalty is \$100, with a maximum penalty of \$50,000. For failing to comply with the public inspection requirements in IRC § 6104(d), the organization is charged \$20 per day for each day the failure continues, up to a maximum of \$10,000 per return. IRC § 6652(c)(1).

Finally, some political committees are required to file periodic disclosures of contributions and expenditures with the IRS. The disclosure requirements do not apply to political committees required to make similar reports to the FEC; state or local committees of political parties; political committees of state or local candidates; organizations which anticipate having gross receipts of less than \$25,000 per year; organizations exempt from tax under other sections of the Code; or to "expenditures" which are "independent expenditures" under FECA.

Political organizations which are required to disclose must report each expenditure of \$500 or more, including the name and address and, if applicable, occupation of the person or organization to whom the expenditure was made; and each contribution of \$200 or more, including the name, address, and, if applicable, occupation and employer of all contributors. Contracts to spend or contribute are treated as contributions or expenditures. The statute applies to expenditures made and contributions received after July 1, 2000. The IRS has issued Form 8872, *Political Organization Report of Contributions and Expenditures*, for use in complying with the periodic reporting requirement.

Political committees reporting to the FEC make similar periodic disclosures of contributions and expenditures in excess of \$200, along with similar identifying information.

Employment tax returns are not subject to public disclosure.

## Requirements for Contributors

Generally, there are no particular requirements placed on contributors to 501(c)(3) organizations. If a contributor wants to take a tax deduction for a contribution of \$250 or more, then the contributor needs to obtain “contemporaneous written acknowledgment of the contribution” by the recipient organization, which includes a description of the contribution and a good faith estimate of the value of any property contributed, and a statement about whether anything of value was given in return for the contribution. No deduction is allowed if a contribution is intended to avoid other tax-law restrictions on lobbying activities.

Most of the contribution requirements fall on the recipient organizations. For example, 501(c)(3) organizations must furnish the acknowledgment to contributors to their organizations. They must obtain the names and addresses of substantial contributors. Political organizations must obtain the names, addresses, occupations, and names of the employers, of all contributors to their organizations. Trade associations and 501(c)(4) organizations whose members might be deducting their dues to the organization have to notify members if a portion of their dues deduction is not tax deductible because of the lobbying activities of the organization.

The information contained in this report is summarized in the following chart.

## Characteristics of and Reporting Requirements for Selected Tax-Exempt Organizations

IRC section	501(c)(3)	501(c)(4)	501(c)(5)	501(c)(6)	527
<b>short-hand name</b>	charity	social welfare organization	labor union	trade association	political organization
<b>charitable contribution deduction</b>	yes	no	no	no	no
<b>business deduction for dues</b>	maybe	maybe (with reduction for lobbying expenses)	employee business expense (with reduction for lobbying expenses)	usually (with reduction for lobbying expenses)	no

<b>taxed on</b>	unrelated business income; political expenditures; excess lobbying expenditures; excess benefit transactions; withholding taxes on employees	unrelated business income; political expenditures; excess benefit transactions; proxy tax on lobbying expenditures withholding taxes on employees	unrelated business income; political expenditures; proxy tax on lobbying expenditures; withholding taxes on employees	unrelated business income; political expenditures; proxy tax on lobbying expenditures; withholding taxes on employees	investment income; other non-political income; all expenditures for non-political purposes; withholding taxes on employees
<b>permitted to lobby</b>	non-substantial amount	yes	yes	yes	to influence the selection of a candidate
<b>permitted to engage in campaign activities</b>	no, but may educate public about issues	yes, but FECA may prohibit certain activities	yes, but FECA may prohibit certain activities	yes, but FECA may prohibit certain activities	yes
<b>application for exempt status</b>	<a href="#">Package 1023</a>	<a href="#">Package 1024</a>	<a href="#">Package 1024</a>	<a href="#">Package 1024</a>	<a href="#">Form 8871</a> , unless exempt or registered with FEC
reports to IRS  (not including employment returns such as <a href="#">Forms</a> 940, 941, W-2, W-3, 1099, and the business income return 990-T)	<a href="#">Form 990</a> or <a href="#">Form 990PF</a> contains: - name, - address, - revenue, - expenses, - total assets, - functional expenses, - program accomplishments. - list of officers, directors, key employees, - compensation of highest paid employees, - compensation of highest paid independent contractors, - major contributors, - relationships with other exempt organizations	<a href="#">Form 990</a> contains: - name, - address, - revenue, - expenses, - total assets - list of officers, directors, key employees, - functional expenses, - program accomplishments, - compensation of highest paid employees, - compensation of highest paid independent contractors	<a href="#">Form 990</a> contains: - name, - address, - revenue, - expenses, - total assets, - list of officers, directors, key employees, - functional expenses, - program accomplishments, - compensation of highest paid employees, - compensation of highest paid independent contractors	<a href="#">Form 990</a> contains: - name, - address, - revenue, - expenses, - total assets, - list of officers, directors, key employees, - functional expenses, - program accomplishments, - compensation of highest paid employees, - compensation of highest paid independent contractors	<a href="#">Form 8872</a> (unless filing with FEC or otherwise exempt); contains: - name, - address, - custodian of records, - contributors' names, addresses, amounts given, - itemized expenditures  <a href="#">Form 990</a>  presumably the same as other 990s, but still in draft form  <a href="#">Form 1120-POL</a> contains: - name, - address - income - expenses - tax

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public disclosure of Form 990	yes, but major contributors (contributions over \$5,000) are not disclosed	yes	yes	yes	yes; major contributors will be disclosed
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The forms are available on the IRS web site:

[http://www.irs.gov/forms\\_pubs/forms.html](http://www.irs.gov/forms_pubs/forms.html)