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Application Process for Seeking 501(c)(3) Tax-Exempt Status

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Summary

Charities and other entities seeking tax-exempt status as 501(c)(3) organizations generally must apply to the Internal Revenue Service. This report provides an overview of the application process.¹

Organizations Eligible for Section 501(c)(3) Status

The organizations described in section 501(c)(3) of the Internal Revenue Code qualify for tax-exempt status. Section 501(c)(3) reads:

Corporations, and any community chest, fund, or foundation, 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 (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual, no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation (except as otherwise provided in subsection (h)), 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.

Organizations that meet these qualifications must generally apply to the Internal Revenue Service (IRS) for recognition of their section 501(c)(3) status.

Exceptions. Some organizations do not have to seek recognition from the IRS of their tax-exempt status. These include churches, their integrated auxiliaries, and

¹ Further information and the forms referenced in this report are available on the IRS website at [<http://www.irs.gov>]. In particular, IRS Publication 557, *Tax-Exempt Status for Your Organization*, may be useful. For general information on tax-exempt organizations, see CRS Report 96-264, *Frequently Asked Questions about Tax-Exempt Organizations*, by Erika Lunder.

conventions and associations of churches. Additionally, organizations with less than \$5,000 in annual gross receipts generally do not have to apply for recognition.

When to File

An organization should try to file the application soon after its formation. If the application is filed within 27 months of the organization's formation, the exemption will generally be effective back to the date of formation. The IRS may grant an extension depending on the circumstances. If the organization does not file its application in a timely manner, it will generally not be treated as an exempt organization for the period between its formation and the postmark date on the application.

Filing Requirements

An organization seeking tax-exempt status must file an application (Form 1023) that shows it meets the organizational and operational requirements in section 501(c)(3).² The application asks questions concerning a variety of areas related to the organization's activities. The organization's operations must be described and organizing documents, such as articles of incorporation or association, must be included. There are detailed questions about the compensation of and dealings with directors and highly-compensated employees. The organization must complete financial statements for the current year and previous three years — a new organization may complete a financial statement for the current year and budget proposals for the next two years. Additionally, the application must include the organization's Employer Identification Number, which may be obtained online or by telephone, and, if applicable, a power of attorney authorization (Form 2848). The IRS may require additional information.

User Fee. As part of the application, organizations must pay a user fee. The fee is \$150 for organizations with average annual gross receipts of less than \$10,000 and \$500 for all other organizations. A new organization should use its expected average receipts to determine which fee is appropriate.

Public Charity v. Private Foundation

On the application, the organization will need to tell the IRS that it is either a public charity or a private foundation. In general, public charities receive contributions from a variety of sources and private foundations receive contributions from limited sources. Due to fear of abuse, private foundations are subject to stricter regulation than public charities. An organization is a private foundation unless it can show the IRS that it is a public charity. Some organizations, such as churches, schools, and hospitals, automatically qualify to be public charities. Other organizations will be classified as public charities if they can show the IRS that they receive substantial public support.

² In 2004, the IRS revised Form 1023. The revision simplified the form, consolidated several other forms into Form 1023, and included more specific questions to make it less likely that the IRS will need to contact the organization for additional information.

Organizations seeking a group exemption letter do not apply using Form 1023. For more information, see IRS Publication 557, *Tax-Exempt Status for Your Organization*.

Advance Rulings. An advance ruling allows a new organization to be treated as a public charity even though it is unable to show the IRS that it receives sufficient public support. The intent is to allow an organization to have five years in which to develop operations to obtain the necessary support. An organization can request an advance ruling on Form 1023. The organization should be able to show that it reasonably expects to be publicly supported during the advance ruling period. If the IRS grants the request, the organization will be treated as a public charity for five years and then must prove to the IRS that it receives substantial public support for the treatment to continue.

IRS Determination of 501(c)(3) Status

Applications are sent to IRS Exempt Organization (EO) Determinations. EO Determinations determines whether the organization meets the exemption requirements by looking at the statutory language, IRS regulations, and such sources as IRS revenue rulings. EO Determinations may ask an organization for further information. Difficult cases, e.g., where there is no precedent or technical advice is needed, are referred to the EO Technical Office at IRS Headquarters. An organization may request a referral to this office for an issue requiring technical advice.

If the IRS approves the application, a favorable determination letter is sent to the organization. As discussed above, if the application for 501(c)(3) status was filed in a timely manner, the exemption will generally be effective back to the date of the organization's formation. The organization may then seek a refund for any taxes since its formation. The exemption will not be effective back to formation if the IRS requires the organization to make changes in its structure or operations in order to receive the exemption or if the application was not timely filed. In both cases, the effective date of the exemption will be provided in the determination letter.

Once the exemption has been approved, the organization may generally continue to rely on its 501(c)(3) status unless there is a material change in the organization's purpose or activities that is inconsistent with the exemption requirements. Additionally, events outside of the organization's control may affect its status, including new legislation, treaties, court decisions, or regulations.

Adverse Determinations. If the IRS decides to deny the exemption, the organization is notified before the determination is finalized. The organization may generally supplement its application with additional information to try to correct the problem. If the IRS does issue a final adverse determination, then the organization may appeal the decision to the IRS Appeals Office or, if appropriate, IRS Headquarters. Once the organization has exhausted its administrative appeals, it may, subject to numerous requirements, file an appeal in the federal courts.

Length of Determination Process

The IRS expects to respond to an exemption application within four months of the application's receipt. In 2002, the IRS estimated the average review was 91 days.³ A common reason for delays is the organization's application has incomplete information.

Expedited Review. The IRS has internal procedures that allow for expedited review of an application when:

- an organization has a pending grant and the failure to secure the grant may have an adverse impact on the organization's ability to continue operations,
- an organization is intended to provide relief to disaster victims,
- the determination process was delayed due to the fault of the IRS, or
- EO Determinations management determines that expedited review is warranted for a situation not listed above.⁴

An organization must include a request for expedited review in its application. The management at EO Determinations decides whether the review will be given priority treatment.

An example of the IRS using an expedited review procedure occurred after September 11, 2001. On September 18, 2001, the IRS announced it would give priority treatment to applications of charities formed to respond to the events of September 11.⁵ Organizations seeking expedited approval wrote "Disaster Relief, Sept. 11, 2001" at the top of Form 1023. The IRS estimated that the average review of these applications was seven days.⁶

³ General Accounting Office, *Tax-Exempt Organizations: Improvements Possible in Public, IRS, and State Oversight of Charities*, GAO Report 02-526 (April 2002).

⁴ Internal Revenue Manual 7.21.3.4.1 (01-01-2003).

⁵ IRS News Release IR-2001-82 (September 18, 2001).

⁶ General Accounting Office, *Tax-Exempt Organizations: Improvements Possible in Public, IRS, and State Oversight of Charities*, GAO Report 02-526 (April 2002).