

How to Obtain 501(c)(3) Tax-Exempt Status for Your Nonprofit

How to apply for tax-exempt status for your nonprofit.

Obtaining federal tax-exempt status is a critical step in forming a nonprofit organization -- most of the real benefits of being a nonprofit flow from your 501(c)(3) tax-exempt status (such as the tax-deductibility of donations, access to grant money, and income and property tax exemptions). (For general information on forming a nonprofit corporation, which is the first step, read Nolo's article *How to Form a 501(c)(3) Nonprofit Corporation*.)

To apply for tax-exempt status, you must complete IRS Form 1023, *Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code*. Completing this form can be a daunting task because of the legal and tax technicalities you'll need to understand. We can't give you complete instructions on how to complete the form in this article because it is so complicated; for that, get *How to Form a Nonprofit Corporation*, by Anthony Mancuso (Nolo). Here we provide an overview of the form so you can familiarize yourself with the type of questions you'll be asked to address.

When to File For 501(c)(3) Status

To get the most out of your tax-exempt status, you'll want to file your Form 1023 within 27 months of the date you file your nonprofit articles of incorporation. (For more information on articles of incorporation, read Nolo's article *Nonprofit Formation Documents: Articles of Incorporation, Bylaws, and Organizational Minutes*.) If you file within this time period, your nonprofit's tax exemption takes effect on the date you filed your articles of incorporation (and all donations received from the point of incorporation will be tax deductible). If you file later than this and can't show "reasonable cause" for your delay (that is, convince the IRS that your tardiness was understandable and excusable), your tax-exempt status will begin as of the postmark date on your IRS Form 1023 application.

How to Prepare Your Tax Exemption Application

Now let's take a look at the Form 1023. It's divided into 11 parts, with each part covering certain information.

Obtain a Current Version of Form 1023

You can obtain a copy of Form 1023 from the IRS website at www.irs.gov or by calling 800-TAX-FORM. The form currently available from the IRS (dated June 2006) does not reflect new rules adopted by the IRS relating to public charity status and the information required in Part IX and Part X of the application. Before completing your Form 1023, go to the IRS website at www.irs.gov to see if a newer Form 1023 than the June 2006 version is available. If not, fill out the June 2006 version and follow the IRS's instructions for Part IX and Part X of the application that are posted on their website (see "Errata Sheet for Form 1023" at www.irs.gov).

Identification of Applicant

This section tells the IRS who you are and asks for basic information like the name of your nonprofit corporation, contact information, and when you filed your articles of incorporation.

Your nonprofit must have a federal employer identification number (EIN) prior to applying for 501(c)(3) tax exemption, even if it doesn't have employees. If your organization held an EIN prior to incorporation, you must obtain a new one for the nonprofit corporate entity. For information on how to apply for an EIN, including information about applying online, visit the IRS website at www.irs.gov.

Organizational Structure

This section requires that you attach a copy of your articles of incorporation and your bylaws to the application form. (Most nonprofits seeking 501(c)(3) status are corporations. If your entity is an LLC, unincorporated association, or nonprofit trust, you should seek the help of a lawyer with experience in nonprofit tax law to complete your Form 1023 application.)

Required Provisions in Your Organizing Document

There are certain clauses that you must have in your articles of incorporation in order to get your 501(c)(3) exemption:

- a clause stating that your corporation was formed for a recognized 501(c)(3) tax-exempt purpose (e.g., charitable, religious, scientific, literary, and/or educational), and
- a clause stating that any assets of the nonprofit that remain after the entity dissolves will be distributed to another 501(c)(3) tax-exempt nonprofit -- or to a federal, state, or local government for a public purpose.

In this section, you state where these clauses can be found in your articles (by page, article, and paragraph).

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Narrative Description of Your Activities

Here you provide a detailed, narrative 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 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).

Compensation and Financial Arrangements

The purpose of this section is to prevent people from creating and operating a nonprofit for the sole benefit of the nonprofit's founders, insiders, or major contributors. In this section, you give information about all proposed compensation to and financial arrangements with:

- initial directors
- initial officers (such as the president, chief executive officer, vice president, secretary, treasurer, chief financial officer, or any other officer in your organization)
- trustees
- the five top-paid employees who will earn more than \$50,000 per year, and
- the five top-paid independent contractors who will earn more than \$50,000 per year.

In computing the amount of compensation paid, include employer contributions made to employee benefit plans, 401(k)s, IRAs, expected bonus payments, and the like. You must also answer questions relating to possible conflicts of interest, which is an important part of the application.

Members and Others That Receive Benefits From the Nonprofit

If your nonprofit will provide goods or services as part of its exempt purpose activities, you must report this on Form 1023. The IRS wants to ensure that your nonprofit is set up to provide goods and services to all members of the public -- or at least a segment of the public that is not limited to particular individuals.

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Your History

If your nonprofit is a “successor” to an incorporated or preexisting organization (such as an unincorporated association), the IRS wants to know. Your nonprofit is most likely a successor organization if it has:

- taken over the activities of a prior organization
- taken over 25% or more of the assets of a preexisting nonprofit, or
- been legally converted from the previous association to a nonprofit.

Details on Your Specific Activities

This part asks about certain types of activities, such as political activity and fundraising, that the IRS scrutinizes closely. For example:

- 501(c)(3) nonprofit organizations may not participate in political campaigns (although some voter education drives and political debate activities are permitted).
- Certain types of fundraising are restricted, including bingo and gaming activities, fundraising for other nonprofits, or using a professional fundraiser.

Financial Data

All groups wishing to obtain 501(c)(3) exempt status must provide a statement of revenues and expenses and a balance sheet. Under new rules in effect since September 9, 2008, an organization that has been in existence for five years or more must provide financial data for its most recent five years. Other groups must provide financial data for each year they have been in existence and good faith estimates for future years for a total of three or four years, depending on how long the organization has been in existence.

These revised financial data requirements relate to new IRS rules that automatically classify all new 501(c)(3) groups as public charities as long as they can show in their Form 1023 that they reasonably expect to receive qualifying public support. If your nonprofit is a public charity, you will want to include all the information necessary to avoid misclassification as a private foundation.

Public Charity or Private Foundation

This section relates to your nonprofit’s classification as a public charity or private foundation. Public charities, which include churches, schools, and hospitals, derive most of their support from the public or receive most of their revenue from activities related to tax-exempt purposes. Most groups want to be classified as a public charity because private foundations are subject to strict operating rules and regulations.

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Under new IRS regulations effective September 9, 2008, all new 501(c)(3) groups will automatically be classified as public charities for the first five years as long as they demonstrate in their Form 1023 that they reasonably expect to receive qualifying public support. These new rules eliminate the requirement that new groups applying for 501(c)(3) tax-exempt status seek an advance ruling on their public charity status.

For the first five years, the group will maintain its public charity status regardless of how much public support it actually receives. After the initial five year period, the IRS will start to monitor whether the group receives the public support necessary to qualify as a public charity.

Fee Information

You must pay a fee when you submit your Form 1023 application. This part of the application asks questions to determine the amount of your fee, which is determined according to the amount of gross receipts your group has or expects to receive annually (averaged over a four-year period).

After You File

After reviewing your application, the IRS will do one of three things:

- grant your federal tax exemption
- request further information, or
- issue a proposed adverse determination (a denial of tax exemption that becomes effective 30 days from the date of issuance).

If you receive a proposed denial of tax-exempt status and you wish to appeal, see a lawyer immediately.