

Organizational Test – IRC 501(c)(3)

By Elizabeth Ardoin

Overview

Purpose

“The difference between the right word and the almost right word is the difference between lightning and the lightning bug.” Mark Twain

This article addresses specific issues that have arisen in determining whether the organizational test is satisfied. The organizational test requires that the articles of organization (hereafter “creating document”) of an organization described in IRC 501(c)(3) contain an explicit statement that its purposes are 501(c)(3) exempt purposes. The organizational test also requires an appropriate dissolution provision unless operation of state law or court action produces the same result. Private foundations have additional organizational test requirements.

An organization’s creating document may be articles of incorporation, articles of association, trust indenture, or constitution. A limited liability company’s (LLC’s) creating document is its state-approved articles of organization. If an LLC has adopted an operating agreement then this document is part of the creating document, but it would not, separately, be required to meet the organizational test. The required provisions in the creating document or state law are important because they subject an organization to enforcement of these provisions by appropriate Federal, State, and judicial authorities.

Most of the issues will be illustrated using a Question-and-Answer (Q & A) approach, along with numerous examples.

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Exempt Purposes and Dedication of Assets

Exempt Purposes and Dedication of Assets

An organization is organized exclusively for one or more 501(c)(3) exempt purposes only if its creating document:

- Limits the purposes of such organizations to one or more exempt purposes,
- Does not expressly empower the organization to engage, other than as an insubstantial part of its activities, in activities which in themselves are not in furtherance of one or more exempt purposes, and
- Permanently dedicates the organization's assets to 501(c)(3) purposes on dissolution.

See Reg. 1.501(c)(3)-1(b)(1)(i) and 1.501(a)(3)-1(b)(1)(4).

The organizational test must be met by the creating document or state law. It cannot be met by oral representations or representations made in other documents. See Reg. 1.501(c)(3)-1(b)(1)(iv).

501(c)(3) Exempt Purposes

Exempt purposes are described in IRC 501(c)(3) and the applicable regulations. Exempt purposes described in IRC 501(c)(3) are:

- Charitable
 - Religious
 - Educational
 - Scientific
 - Literary
 - Testing for public safety
 - Fostering national or international amateur sports competition
 - Preventing cruelty to children or animals.
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Exempt Purposes and Dedication of Assets, Continued

Specific Charitable Purposes

The exempt purposes described in 501(c)(3) regulations encompass the general legal definition of the term “charitable.” The regulations list the following specific charitable purposes:

- Relief of the poor, the distressed, or the underprivileged;
- Advancement of religion
- Advancement of education or science
- Erecting or maintaining public buildings, monuments, or works
- Lessening the burdens of government
- Lessening neighborhood tensions
- Eliminating prejudice and discrimination
- Defending human and civil rights secured by law
- Combating community deterioration and juvenile delinquency

See Reg. 1.501(c)(3)-1(d)(2).

More 501(c)(3) Regulations Purposes

The 501(c)(3) regulations also include the exempt purpose of receiving contributions and paying them over to organizations that are described in IRC 501(c)(3). See Reg. 1.501(c)(3)-1(b)(1)(ii).

Finally, these regulations note the exempt purpose of operating of a school for education when the creating document describes in detail the manner of the operation of such school. See Reg. 1.501(c)(3)-1(b)(1)(ii).

Publication 557

Publication 557, *Tax-Exempt Status for Your Organization*, (Rev. May 2003), at Chapter 3, *Articles of Organization*, contains samples of language that will meet the organizational test. However, other language may also satisfy the organizational test. For example, charitable purposes specified in revenue rulings and court decisions may be referenced. Publication 557 may be accessed at:

- (800) 829-3676 to order IRS tax forms and publications
 - www.irs.gov.
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Exempt Purposes: Q & A's and Examples

Q.1: Purposes Described in IRC 501(c)(3)

Q1. Must an organization's creating document contain a provision expressly limiting its purposes to one or more exempt purposes?

A1. Yes. The creating document must refer to purposes that come within those described in IRC 501(c)(3). This may be accomplished by a statement that it is formed for charitable, religious, educational, scientific, or other purposes referred to in IRC 501(c)(3) or the applicable regulations. The purposes do not have to expressly refer to IRC 501(c)(3). See Reg. 1.501(c)(3)-1(b)(1)(ii).

Examples of Acceptable and Unacceptable Purposes

Example: If a creating document states that the organization is formed to operate for educational purposes, this statement would satisfy the purpose requirement since the term "educational" is contained in IRC 501(c)(3).

Example: If a creating document states that the organization is formed to eliminate prejudice and discrimination, this statement would satisfy the purpose requirement since the term "eliminate prejudice and discrimination" is contained in Reg. 1.501(c)(3)-1(d)(2).

Example: If a creating document states that the organization is formed to operate a school, this statement would not satisfy the purpose requirement. The term "school" is not contained in IRC 501(c)(3) or the applicable regulations. To operate a school does not necessarily further an exempt purpose. See Reg. 1.501(c)(3)-1(b)(1)(ii).

Example: If a creating document states that the organization is formed to operate a school for educational purposes, this statement would satisfy the purpose requirement.

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Exempt Purposes: Q & A's and Examples, Continued

Examples of Acceptable and Unacceptable Purposes, continued

Example: If a creating document states that an organization was formed to promote health, this statement would not satisfy the purpose requirement. To promote health does not necessarily further an exempt purpose. For example, a hospital might promote health by providing medical care without necessarily dedicating itself to the promotion of health in a charitable manner as described in Rev. Rul. 69-545, 1969-2 C.B. 117.

Example: If a creating document states that the organization was formed to operate a medical clinic to serve the health care needs of the community exclusively in furtherance of charitable purposes, this statement would satisfy the purpose requirement of the organizational test.

Q.2: Effect of the “Notwithstanding” Clause

Q2. If a creating document contains a purpose that does not necessarily accomplish exempt purposes as described in IRC 501(c)(3), should the organization amend its creating document to limit its purpose to those described in IRC 501(c)(3)?

A2. Yes. However, if the creating document contains a purpose that does not satisfy the organizational test, but such purpose is not expressly contrary to 501(c)(3) exempt purposes, the following type of provision in the creating document will meet the purpose requirement of the organizational test: “Notwithstanding other language (or provisions) in the creating document, the purposes will be limited exclusively to exempt purposes within the meaning of IRC 501(c)(3).” In this circumstance, no further amendment is necessary. This type of provision is generally referred to as a “notwithstanding clause.” See Reg. 1.501(c)(3)-1(b)(1)(iii).

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Exempt Purposes: Q & A's and Examples, Continued

Examples of the “Notwith- standing Clause”

Example: A creating document provides that an organization is formed to promote philanthropic and eleemosynary purposes. This statement would not satisfy the purpose requirement. But, if the creating document also states that notwithstanding any other provision in this instrument, it will not further any specified purpose to more than an insubstantial degree other than those described in IRC 501(c)(3), the organization would not have to amend its creating document to meet the purpose requirement of the organizational test.

Example: A creating document provides that an organization is formed to provide scholarship assistance to individuals. Without further limitation, the term “providing scholarship assistance to individuals” could describe purposes outside the scope of IRC 501(c)(3). For example, the term could include providing financial assistance to children who are pre-selected by the organization’s founder. Therefore, this statement would not satisfy the purpose requirement of the organizational test.

Example: A creating document provides that an organization is formed to provide scholarship assistance to individuals. It also provides that notwithstanding any other provision in this instrument, it will not further any specified purpose to more than an insubstantial degree other than those described in IRC 501(c)(3). This statement would satisfy the purpose requirement of the organizational test.

Example: A creating document provides that an organization is formed to promote educational and political purposes. Educational purposes come within the scope of the purposes described in IRC 501(c)(3); however, political purposes include intervening in political campaigns, which is specifically prohibited. Therefore, a notwithstanding clause would not be sufficient because the creating document contains a purpose that cannot be limited to make it fit within the scope of exempt purposes described in IRC 501(c)(3).

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Exempt Purposes: Q & A's and Examples, Continued

Q.3: Effect of Limitations on Activities

Q3. If a creating document contains purposes outside of those described in IRC 501(c)(3) but expressly states that the organization will not engage in *activities* other than those described in IRC 501(c)(3), does this satisfy the *purpose* requirement?

A3. No. A provision in an organization's creating document limiting its *activities* to those described in IRC 501(c)(3) would not cure an overly broad *purpose* statement.

Example of Effect of Limitations on Activities

Example: A creating document states that an organization is formed to provide tutoring. The instrument also states that notwithstanding other language in the creating document, it will not engage in activities that are not described in IRC 501(c)(3). The provision of tutoring does not necessarily accomplish exempt purposes within the meaning of IRC 501(c)(3). If the notwithstanding clause had limited the organization's *purposes* to those described in IRC 501(c)(3), rather than its *activities*, no amendment would be necessary. Limiting the organization's activities does not correct its overly broad purposes statement.

Q.4 & 5: Cross-referencing IRC 170

Q4. If a creating document contains a purpose clause that provides that the organization will limit its purposes to those carried out by organizations described in IRC 501(c)(3) or organizations contributions to which are deductible under IRC 170, should the organization amend its creating document to limit its purposes to those described in IRC 501(c)(3)?

A4. Yes. IRC 170(c) refers to charitable contributions rather than charitable purposes. Under that section, contributions to organizations other than those described in IRC 501(c)(3) are treated as charitable contributions. For example, IRC 170(c)(5) refers to contributions to a cemetery company. Thus, a creating document stating that an organization's purposes will be limited to those carried out by organizations described in IRC 170 would allow an organization to operate a cemetery.

Q5. If a creating document refers to IRC 170(c)(1) or (c)(2) instead of IRC 170, should the organization amend its creating document to limit its purposes to those described in IRC 501(c)(3)?

A5. No. IRC 170(c)(1) refers to contributions to a government entity exclusively for a public purpose and IRC 170(c)(2) refers to contributions for purposes that are consistent with those described in IRC 501(c)(3).

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Exempt Purposes: Q & A's and Examples, Continued

**Q.6:
Limitations on
Prohibited
Activities**

Q6. Must an organization's creating document include language that:

- Prohibits the inurement of net earnings to its members, trustees, officers, or other private persons;
- Limits its activities to those described in IRC 501(c)(3);
- States that no substantial part of the activities of the organization shall be the carrying on of propaganda, or otherwise attempting to influence legislation; and/or,
- States that the organization will not participate in or intervene in a political campaign on behalf of or in opposition to a candidate for public office?

A6. The Code and Regulations do not require any of these four specific provisions to be stated in a creating document. Thus, no amendment is necessary unless the creating document:

- Expressly states that there will be inurement of net earnings, such as a statement that the profits of the organization will be distributed to its members, officers, directors or other individuals;
- Describes activities that are outside the scope of IRC 501(c)(3) and does not indicate that such activities will be insubstantial;
- Expressly states that the organization will be engaged in the carrying on of propaganda, or otherwise attempting to influence legislation but does not indicate that the activities will be insubstantial or will come within the limits set forth in IRC 501(h); or,
- Expressly states that the organization participates in, or intervenes in, any political campaign on behalf of or in opposition to any candidate for public office.

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Exempt Purposes: Q & A's and Examples, Continued

Example of Limitations on Prohibited Activities

Example: A creating document provides that an organization is formed for educational purposes. It also provides that the organization will be attempting to influence legislation. The creating document does not state that the legislative activities will be insubstantial. Therefore, the organization would need to specifically state that legislative activities will be insubstantial.

In this case, the organization would only need to add this restriction on influencing legislation and would otherwise not need to add any of the other limitations provisions listed in Q.6.

Q.7: Express Allowance of Prohibited Activities

Q7. If the organization has to amend its creating document for other reasons, can it be required to prohibit the activities described at Q.6?

A7. No. We may suggest that the organization consider adding language to that effect. However, we must also state that it is not required. See Reg. 1.501(c)(3)-1(b)(3).

Dissolution Provision: Q & A's

Q. 8: Effect of No Dissolution Provision and State Law Remedies

Q8. Must an organization's creating document permanently dedicate its assets to an exempt purpose?

A8. Yes. An organization will not qualify for exemption unless its creating document contains a dissolution provision that permanently dedicates its assets to an exempt purpose. Publication 557, *Tax-Exempt Status for Your Organization*, (Rev. May 2003), at Chapter 3, *Articles of Organization*, contains samples of language that will meet the dissolution provision requirement.

However, an organization can also meet the dissolution provision requirement if, by operation of State law or court action, its assets would be distributed for one or more exempt purposes, or to the Federal government, or to a State or local government, for a public purpose, even though a specific dissolution provision is not contained in its creating document.
See Reg. 1.501(c)(3)-1(b)(4).

For purposes of determining whether an organization will meet the dissolution provision requirement by operation of State law or court action Rev. Proc. 82-2, 1982-1 C.B. 367 provides that:

1. **Nonprofit charitable corporations** located in one of the states listed would not be required to include a dissolution provision in its creating document. This exception only applies to corporations. Any unincorporated nonprofit association needs an adequate dissolution provision in its organizing document.
2. **Charitable testamentary trusts** located in: a) one of the states listed would not be required to include a dissolution provision in its creating document, b) one of states listed would not be required to include a dissolution provision in its creating document if the settlor has demonstrated a general charitable intent in the language of the trust instrument, or c) one of the states listed in which the creating document always needs to include a dissolution provision.
3. An *inter vivos* **charitable trust**, except in Delaware, should be required to have an adequate dissolution provision in its creating document.

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Dissolution Provision: Q & A's, Continued

Q.9 & 10 Substitutes for “Exempt Purpose”

Q9. How does the organizational test apply to an organization whose creating document specifies that upon dissolution its assets will be distributed to a State or local government?

A9. An organization's creating document must specify that its assets must be used for a public purpose if they are to be distributed upon dissolution to a State or local government. See Reg. 1.501(c)(3)-1(b)(4).

IRC 115(l) excepts from federal income tax amounts derived from the exercise of any essential governmental function and accruing to a State, any political subdivision thereof or the District of Columbia. Rev. Proc. 2003-12, 2003-4 I.R.B. 316 provides guidance on the dissolution provision for an organization described in IRC 501(c)(3) that requests a letter ruling that its income is excluded from gross income under IRC 115(l). This revenue procedure also provides examples of appropriate dissolution provisions. A copy of Rev. Proc. 2003-12 is Exhibit 1.

Q10. The language at Reg. 1.501(c)(3)-1(b)(4) provides that the assets of an organization described in IRC 501(c)(3) must be “dedicated to an exempt purpose.” In that section, it does not expressly refer to IRC 501(c)(3). Does this mean that a dissolution provision that refers to an exempt purpose without further limitation is sufficient?

A10. No. Reg. 1.501(c)(3)-1(a)(2) provides that for purposes of Reg. 1.501(c)(3)-1, the term “exempt purpose or purposes” means any purpose or purposes specified in IRC 501(c)(3). Accordingly, the reference to an exempt purpose at Reg. 1.501(c)(3)-1(b)(4) would include only those purposes described in IRC 501(c)(3). Thus, the creating document must expressly refer to IRC 501(c)(3) unless the language in the creating document indicates that the assets will be distributed:

- A. For charitable purposes;
- B. For purposes identical to those of the organization; or,
- C. To a governmental entity exclusively for a public purpose.

Where the assets will be distributed for purposes identical to those of the organization, a provision to that effect is sufficient. The organization need not repeat the language that appears in its purposes provision.

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Dissolution Provision: Q & A's, Continued

**Q.11: Assuring
Permanent
Dedication of
Assets**

Q11. If the creating document indicates that the assets will be distributed to a particular organization that is described in IRC 501(c)(3), must it provide a contingency clause ensuring that the assets will be dedicated to a charitable purpose in the event the named organization is unwilling to accept its assets, is no longer described in IRC 501(c)(3), or is no longer in existence?

A11. Yes. Reg. 1.501(c)(3)-1(b)(4) requires that an adequate dissolution provision must specify that upon the dissolution of the organization its assets shall be distributed for one or more exempt purposes within the meaning of IRC 501(c)(3), or shall be distributed to the Federal government, or to a State or local government, for a public purpose. State law or court action of the type described in Rev. Proc. 82-2 satisfies the requirement for a dissolution provision where there is no provision in the creating document. However, if the creating document contains a dissolution provision that is defective, state law or court action would not cure the defect.

Private Foundations

Private Foundations and IRC 508(e)

Under IRC 508(e), a private foundation's creating document must contain certain provisions concerning IRC 4941, 4942, 4943, 4944, and 4945.

Publication 557, *Tax-Exempt Status for Your Organization*, (Rev. May 2003), at Chapter 3, *Private Foundations and Public Charities*, contains samples of language that will meet this private foundation requirement. However, other language may also satisfy this requirement.

Rev. Rul. 75-38, 1975-1 C.B. 161 identifies those states that have adopted legislation satisfying the requirements of IRC 508(e). Therefore, the governing instruments of private foundations located in those states are considered to satisfy the requirements of IRC 508(e) if additional specific requirements listed for each state are met.

Conclusion

Conclusion

The organizational test is a technical requirement that an organization must satisfy to be qualified for tax exempt status under IRC 501(c)(3). However, it should not be applied to compel an organization to add language to its creating document that is not required.

Exhibit 1

January 27, 2003

SECTION 1. PURPOSE

This Revenue Procedure provides guidance on dissolution provisions for any organization described in § 501(c)(3) and exempt from federal income tax under § 501(a) of the Code that requests a letter ruling that its income is excluded from gross income under § 115(1).

SECTION 2. BACKGROUND

.01 Section 115(1) of the Code provides that gross income does not include income that is (i) derived from a public utility or from the exercise of any essential governmental function (the "essential government function test"), and (ii) accruing to a State, any political subdivision thereof, or the District of Columbia (the "accrual test"). An entity is not required to obtain a ruling from the Service to claim an exclusion from gross income under § 115(1).

.02 One aspect of the accrual test of § 115(1) is that assets of the organization must be distributed upon the organization's dissolution to one or more States, political subdivisions thereof, the District of Columbia, or to other organizations the income of which is excluded from gross income under § 115(1) (the "distribution of assets upon dissolution requirement"). The assets of an entity described in § 115(1) may not be distributed upon dissolution (or at any other time) to the United States government. *See* Rev. Rul. 90-74, 1990-2 C.B. 34; Rev. Rul. 77-261, 1977-2 C.B. 45; Rev. Rul. 71-589, 1971-2 C.B. 94. An organization seeking a ruling under § 115(1) will not be found to satisfy the distribution of assets upon dissolution requirement of the § 115(1) accrual test if its articles of organization fail to limit distribution of all the organization's assets upon dissolution to one or more States, political subdivision(s) thereof, the District of Columbia, or to other organizations whose income is excluded from gross income under § 115(1).

.03 An organization may be described in § 501(c)(3) of the Internal Revenue Code and its income may also be excluded from gross income under § 115(1). *See* Treas. Reg. § 1.6033-2(g)(1)(v) (a state institution exempt from taxation under § 501(a) the income of which is excluded from gross income under § 115(a) (now § 115(1)) is not required to file an annual information return on Form 990, *Return of Organization Exempt From Income Tax*); *see also* Rev. Proc. 95-48, §§ 3.01, 4.02, 1995-2 C.B. 418.

.04 To qualify as an organization described in § 501(c)(3) and exempt from federal income tax under § 501(a), an organization must meet the requirements of the organizational test of § 501(c)(3). One requirement of the organizational test is that the assets of the organization be dedicated to an exempt purpose. Treas. Reg. § 1.501(c)(3)-1(b)(4).

.05 A § 501(c)(3) organization's articles of organization must contain a dissolution clause that satisfies the organizational test of § 1.501(c)(3)-1(b)(4) of the Treasury Regulations, unless the organization is organized under State laws that satisfy the distribution of assets upon dissolution provisions of § 1.501(c)(3)-1(b)(4). *See* Treas. Reg. § 1.501(c)(3)-1(b)(4); Rev. Proc. 82-2, 1982-1 C.B. 367.

SECTION 3. APPLICATION

A § 501(c)(3) organization can satisfy the organizational test of § 1.501(c)(3)-1(b)(4) of the Treasury Regulations by reason of its articles of organization or by operation of law. However, for purposes of obtaining a § 115(1) ruling, a § 501(c)(3) organization will not satisfy the "distribution of assets upon dissolution requirement" of § 115(1) unless its articles of organization also limit distribution of assets on dissolution (to the extent consistent with § 1.501(c)(3)-1(b)(4)) to one or more States, political subdivisions of States, the District of Columbia, or other organizations the income of which is excluded under § 115(1). For purposes of obtaining a § 115(1) ruling, the organization may not rely on a provision of state law to satisfy the distribution of assets upon dissolution requirement of § 115(1).

SECTION 4. EXAMPLES

.01 Organization A is exempt from federal income tax under § 501(a) as an organization described in § 501(c)(3). Organization A has a dissolution clause in its articles of organization that satisfies Treas. Reg. § 1.501(c)(3)-1(b)(4). Organization A's articles state that, upon dissolution, any assets remaining after the payment of debts and the satisfaction of liabilities are to be distributed (1) to an organization described in § 501(c)(3) for one or more exempt purposes, or (2) to the United States government, or to a State or local government, for a public purpose. Organization A requests a letter ruling that its income is excluded from gross income under § 115(1). Although the dissolution clause in the articles of Organization A meets the organizational requirements of § 501(c)(3), the dissolution clause allows for distribution to entities to which distributions may not be made under § 115(1). The dissolution clause, therefore, fails to satisfy the distribution of assets upon dissolution requirement of the accrual test of § 115(1). In these circumstances, a favorable ruling on § 115(1) would not be issued.

.02 Organization B is exempt from federal income tax under § 501(a) as an organization described in § 501(c)(3). Organization B has a dissolution clause in its articles of organization that satisfies Treas. Reg. § 1.501(c)(3)-1(b)(4). Organization B's articles state that, upon dissolution, any assets remaining after the payment of debts and the satisfaction of liabilities are to be distributed either (1) to a State or political subdivision thereof for a public purpose or (2) for one or more exempt purposes to an organization described in § 501(c)(3) and whose income is also excludable from gross income under § 115(1). Organization B requests a letter ruling that its income is excluded from gross income under § 115(1). The dissolution clause in the articles of Organization B meets the requirements of the organizational test of § 501(c)(3) and also satisfies the distribution of assets upon dissolution requirement of the accrual test of § 115(1).

.03 Organization C is exempt from federal income tax under § 501(a) as an organization described in § 501(c)(3). Upon dissolution, Organization C's remaining assets will be distributed by operation of the law of Organization C's state of incorporation to a political subdivision of the state for a public purpose. Organization C requests a letter ruling that its income is excluded from gross income under § 115(1). Although state law provides a dissolution distribution scheme that meets the organizational test of Treas. Reg. § 1.501(c)(3)-1(b)(4), the state's dissolution provision fails to satisfy the accrual test of § 115(1) for purposes of obtaining a § 115(1) letter ruling. In these circumstances, a favorable ruling on § 115(1) would not be issued. To receive a favorable § 115(1) letter ruling, Organization C must have articles of organization that contain a provision satisfying the distribution of assets upon dissolution requirement for the § 115(1) accrual test.

SECTION 5. DRAFTING INFORMATION

The principal author of this revenue procedure is Sara T. S. Wolff of the Office of Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). For further information regarding this revenue procedure, contact Ms. Wolff at (202) 622-