

Tax exemptions for not-for-profit corporations -- understand which may apply



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Not-for-profit corporations provide a wide range of valuable services to Champaign County, from afterschool programs offered by local boys and girls clubs to emergency medical services provided by the local hospitals. Incorporation as a not-for-profit is a logical step for a variety of charitable, religious and other endeavors. However, there are certain important distinctions and requirements which prospective founders should keep in mind.

First is the commonly blurred distinction between a not-for-profit corporation and a tax exempt organization. A not-for-profit corporation is an independent business entity formed by filing articles of incorporation with the Illinois secretary of state. Not-for-profits are governed by the Illinois Not-For-Profit Corporation Act and must have as their stated purpose one of the accepted purposes under that Act. However, incorporation as a not-for-profit does not make the organization a tax exempt organization. For that matter, there are several distinct forms of tax exemption, each of which carries its own requirements and application process.

Generally, the first tax exemption sought by a not-for-profit is relief from federal income tax. Qualification for this exemption is recognized by the Internal Revenue Service upon application by the not-for-profit. Section 501(c) of the Internal Revenue Code provides a list of 28 types of entities which qualify for exemption from federal income tax. The most commonly relied upon exemption is found in section 501(c)(3) and applies to entities "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." This broad sweeping exemption is relied upon by churches, sports leagues, schools and any other organizations that share the stated purposes.

An advantage of a 501(c)(3) designation over some of the other exemptions listed in Section 501(c) is the fact that not only is the entity exempt from income tax, but also any donations made to the organization are tax-deductible for the donor on his personal income tax return. However, a 501(c)(3) exemption also carries two important restrictions. First, no portion of the income of the organization may go to any private shareholder or individual. Employees, directors and officers of a 501(c)(3) organization may be paid for their services, but care must be taken to avoid any payments to individuals beyond fair market value for the services actually performed. Such overpayment could be found to be "private inurement" and may jeopardize the organization's tax exempt status. A second restriction has been particularly relevant during the recent election cycle and prohibits any "substantial portion" of a 501(c)(3) organization's activities from attempting to influence legislation or intervening in any political campaign in support or in opposition to any candidate.

A second commonly used exemption, and one of particular interest to the business community, is 501(c)(6), which applies to business leagues and chambers of commerce. Donations made to a 501(c)(6) are not tax deductible for the individual donor. However, for the most part, businesses will be members of these organizations and will pay membership fees, which are then deductible as an ordinary business expense. Like 501(c)(3) organizations, no part of the earnings of a 501(c)(6) entity may inure to the benefit of a private shareholder or individual. However, 501(c)(6) organizations are not prohibited from engaging in political or legislative activities.

In addition to the exemption from federal income tax, the state of Illinois offers exemptions from real estate taxes for certain charitable organizations. These exemptions apply to property owned by schools, religious organizations and orphanages, as well as certain other types of property as long as the property is "actually and exclusively used for charitable or beneficent purposes." This exemption has been the subject of considerable attention recently as the courts work to determine whether our two local hospitals, Provena and Carle, qualify for an exemption.

Finally, certain organizations may be eligible to receive an exemption from sales tax, depending on the circumstances. Organizations may apply to the Illinois Department of Revenue for such an exemption. However, this exemption is fairly narrow and often more difficult to meet than either the real estate or income tax exemptions. Still, it could provide a substantial advantage to a not-for-profit and should be considered.

The list of business and charitable purposes that can be supported by a not-for-profit corporation is fairly broad. However, incorporation as a not-for-profit is only the first step, and founders should consider the multiple exemptions from taxes that may be available. Qualifying for exemption at one level does not guarantee exemption at any other level, since the standards are different, but each exemption helps toward serving the organization's charitable or business purpose.

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