

Nonprofit Purposes

A nonprofit organization may be formed for any legal purpose under most state laws, as long as it does not pass its profits on to its members. However, in order to qualify for favorable tax treatment and gain certain other benefits, it must limit its purposes to those allowed in the Internal Revenue Code (I.R.C.). The following are some of the most popular purposes allowed by the law.

Section 501(c)(3) Organizations

The best tax treatment is available to nonprofits that qualify under Section [501\(c\)\(3\)](#) of the I.R.C. These organizations get both a tax exemption and the ability for their contributors to deduct contributions. The IRS uses two tests to determine if an organization qualifies under Section 501(c)(3): the organizational test and the operational test.

Under the organizational test, the documentation that forms the organization must limit the organization's purpose and activities to those that are permitted. For this reason, it is very important that the articles of incorporation and the bylaws are carefully drafted to meet IRS requirements.

Under the operational test, the operations or activities must also comply with the law. It is not enough that the paperwork of the organization is correct—the organization must also conduct itself in conformance with those rules.

If the purpose or activities of a nonprofit organization do not qualify for an exemption under Section 501(c)(3), it still may claim an exemption under one of the other subsections of 501(c)(3). The disadvantage is that under most of the other subsections, the income is tax-exempt, but contributions may not be deducted on donors' tax returns. Permitted purposes under Section 501(c)(3) include the following:

Religious

Religion is the oldest and broadest category of nonprofit. Because the First Amendment to the Constitution bars the government from making any law that prohibits the free exercise of religion, the government is limited in how much it can regulate religious activities. However, some courts have required newly formed religious groups to be similar to traditional religions, with such things as an established congregation, an organized ministry, regular services, education of the young, and a doctrinal code in order for them to qualify for a tax exemption. This was done to keep people from setting up their own religions just for tax purposes.

Charitable

Under the tax law, the word charitable is broader than the normal definition of relieving poverty. Court decisions over the years have allowed all of the following activities to be undertaken by organizations that qualify for Section [501\(c\)\(3\)](#) status.

- Relieving poverty. Any activity that gives aid to the poor, such as soup kitchens or homeless shelters, may qualify. However, it must direct its benefit to the

public at large and not to any particular person. For example, a group that forms to help a particular family that loses its home in a fire will not qualify for tax-exempt status. To qualify, its purpose would have to be to help all fire victims in a certain area.

- **Beautifying the community.** Groups that plant trees and clean up highways can qualify for charitable status. The limitation is that they must serve a broad community, such as a city or town. If they only serve a limited number of people, such as a subdivision, they will not qualify.
- **Lessening the burdens of government.** Groups that help existing government programs, through activities such as improving parks or police facilities, are included as charitable organizations.
- **Promoting health.** Hospitals, blood banks, clinics, mental health organizations, and groups with similar functions all qualify for charitable status as long as their profits do not go to private individuals.
- **Promoting social welfare.** Groups that promote social welfare are groups that support civil rights, community alliance, national defense, or similar causes.
- **Promoting environmental conservation.** Groups that work to preserve national resources may qualify as promoting environmental conservation.
- **Promoting the arts.** Groups that sponsor arts festivals, theater groups, concerts, and programs to encourage young people to develop their talents are covered.
- **Promoting patriotism.** Groups that participate in patriotic displays and inculcate patriotic emotions are considered groups that promote patriotism.
- **Promoting amateur sports.** Groups that support amateur sports, such as little leagues and soccer clubs, but not simply any group that provides athletic facilities or equipment, may qualify as a charitable organization.

Scientific

Scientific research that is theoretical is clearly allowable for charitable nonprofit organizations, but research that is practical and has business applications is not. Testing products is not considered charitable (unless done for public safety), and doing work for one particular company is clearly not allowed.

Testing for Public Safety

Organizations which test the safety of products may qualify for the exemption.

Literary

Literary organizations are exempt if their work is not commercial, but rather promotes the literacy of the community. For example, a publisher that sells books at normal prices will probably not qualify, but one that sells the works of unknown talented people at a discount price may qualify.

Educational

Educational organizations can include libraries and museums as well as traditional schools, colleges, and universities. For the tax exemption, it is important that the school is an objective place of learning rather than a promoter of a particular idea.

Preventing Cruelty to Children or Animals

Organizations like the Society for the Prevention of Cruelty to Animals (SPCA), orphanages, or any group that aids children or animals are included, as long as the

group is not limited to any particular child or animal.

Other Types of Organizations

The rationale for other types of tax-exempt organizations is completely different from Section 501(c)(3) organizations. While Section 501(c)(3) organizations are exempt because they are perceived to be doing something beneficial to society, the others are not taxed because they are pooling money to do something that would not be taxed if the money were not pooled.

For example, if a number of people use their money to lobby for better roads or to socialize every Sunday night, there is no tax involved. So, if they put their money together in an organization to do the same thing, there is no reason they should have to pay an extra tax on that money.

The problem arises when these groups try to raise money from outside sources. If a social club charges its members \$10 for dinner, but charges outside guests \$20 for the same dinner, then the members who pay less are making a profit on the arrangement. This type of activity by a nonprofit organization is subject to tax.

Some organizations divide their operations into two or more nonprofit organizations. For example, a Section 501(c)(3) organization may have a subsidiary under another 501(c) subsection to perform activities forbidden under Section 501(c)(3) rules.

The following are some of the most common tax-exempt organizations under categories other than Section 501(c)(3).

Civic and Social Welfare Associations

An organization can be formed under Section 501(c)(4) to promote the common good and social welfare of a community. You could use this type of organization if you wanted to do something forbidden to 501(c)(3) organizations, such as lobby for better roads or schools.

Employee Associations

Also under Section 501(c)(4), an association of employees of one employer can be formed if their net earnings are devoted exclusively to charitable, educational, or recreational purposes.

Labor Organizations

A labor or agricultural worker organization can be formed under Section 501(c)(5) if the goal is to improve conditions, production, or efficiency.

Trade Associations

Groups that promote the common interest of a business community or a line of businesses, such as a chamber of commerce or board of real estate, are exempt under Section 501(c)(6). However, the group may not carry on business itself. It may only promote the interests of all businesses in the same field.

The trade association must be involved with only one trade. If it is a group of people from different trades who meet to network, it will not qualify under Section 501(c)(6), though it may be able to qualify as a social club or other type of exempt organization.

It must allow competitors in the same field to be members-it cannot support only one faction of an industry.

Social Clubs

A club that is formed solely for pleasure and recreational purposes is exempt under Section 501(c)(7) if most of its income is from member dues and only an insubstantial amount is raised from the public.

With the strict rules that a nonprofit organization cannot give any benefits to its members, it seems anomalous that a group whose sole purpose is to benefit its members could qualify. However, as explained before, there is no reason to tax groups that merely pool their money to do something that would not be taxed if paid for separately.

In order to qualify as a tax-exempt social club, an organization must have a membership that commingles and has shared interests. Some groups that have qualified are fraternities and sororities, lunch and dinner clubs, golf and tennis clubs, gem collectors, and political clubs. One organization that was disallowed an exemption was an auto club, because the IRS found that the interests of the members were too different.

Cemeteries

If a cemetery is not designed to make a profit, but instead to provide plots exclusively for its members, it can be tax-exempt under Section 501(c)(13).

Veterans' Organizations

If 75% of the members of a veterans' organization are past or present members of the armed forces, and most of the rest are relatives of veterans, it can qualify as tax-exempt under Section 501(c)(19).

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