**MEMORANDUM**

TO: Nelson Ko

Tiki Software Community Association

FROM: Katie Clardy, Team 4

WVU Entrepreneurship & Innovation Law Clinic

DATE: May 9, 2013

SUBJECT: Filing for tax-exempt status in the United States

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This memo will explain the basics of the availability and the process for filing for tax exempt status in the United States. Then this memo will address the advantages and the disadvantages to having tax-exempt status in the United States.

Introduction to the Nonprofit Organization in the United States

A tax exempt organization is a type of nonprofit organization that is exempt from some federal income taxes. Both nonprofit and for-profit organizations make a profit; however, in a nonprofit organization the “profit” is referred to as an excess of revenues over expenses. A nonprofit organization is also different from a for-profit organization in that the nonprofit organization does not distribute its excess revenues to owners or shareholders. Any excess revenues can not inure to the benefit of owners or shareholders, but rather are used to further the nonprofit’s activities.

The Internal Revenue Code Section 501 provides the available exemptions for nonprofit organizations. The most popular exemption is Section 501(c)(3), which provides a tax exemption for nonprofit corporations, organizations, foundations, associations or trusts organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports, or prevention of cruelty for children or animals. The Internal Revenue Service (IRS) will determine whether an organization falls within the different exemptions available by looking at the organization’s purpose. Thus, it is extremely important to draft the purpose carefully.

Process for Establishing Nonprofit Organization

Nonprofit organizations that seek tax exempt status may be structured in three different forms: unincorporated associations, charitable trusts, and nonprofit corporations. As a foreign business, you will have to organize under one of these forms in a state within the United States. The Secretary of State for each state oversees the formation of for-profit and non-profit organization. The cost to create these organizations will vary by state.

For example, in the State of West Virginia the cost of establishing a nonprofit corporation is $25 plus $15 per certified copy, and the cost of establishing an unincorporated non-profit associations is $15. However, in West Virginia, you may also have the option of filing an application for certificate of authority with the Secretary of State for operation of a foreign corporation in West Virginia.

After establishing the nonprofit organization under one of the states of the United States, the nonprofit organization will have to apply for an Employee Identification Number (EIN) and file a 1023Form with the IRS. To apply for an EIN, contact the IRS or use the IRS website. After a series of questions, the IRS will assign an EIN and there are no associated filing fees. The 1023 Form is available on the IRS website and does include a filing fee. Once a nonprofit organization receives tax exempt status, as recognized by the IRS (through the filing and approval of these forms), the organization must maintain this status by completing various yearly filings, usually a Form 990.

Advantages of Tax Exempt Status

The benefits of 501(c)(3) status include:

* Do not pay federal corporate income tax except on income derived from unrelated business income;
* In most cases, do not pay state corporate income, franchise, excise, use and sales tax. The breadth of these state tax exemptions varies by state; and
* A tax deduction for charitable donations.

Disadvantages of Tax Exempt Status

The largest disadvantage of this process is the cost and time spent on completing the required paperwork for establishing and maintaining the nonprofit and tax returns each year. A lot of time and energy are required for setting up accounting systems and record books, drafting bylaws, filing articles of incorporation, and completing IRS forms. Finally, the review process of the application for 501(c)(3) status is slow; it may take up to one year after filing for you to receive tax exempt status.

As you mentioned previously that you have already completed similar paperwork in Canada, you may have access to such cost figures as a comparison. Since we do not have licenses to practice in Canada, we are unable to compare this information to the requirements, impacts or costs the process of filing in Canada. We recommend that you seek Canadian counsel to review such comparisons, impacts or requirements of Canadian law of obtaining a Canadian tax-exempt organization.

Conclusion

This is a basic overview of the process for filing for tax exempt status, specifically 501(c)(3), in the United States. Many of the forms required for filing for tax exempt status are very detailed. If you have any further questions regarding the process or the benefits of tax exempt status in the United States, please let us know.

I am listing two links below to some helpful sources for filing with the IRS; hopefully, this will allow you to compare the United States process to the process you complete in Canada for tax exempt status. The first is Publication 557: Tax-Exempt Status for your Organization. It explains the different exemptions available and the filing process. The second is Form 1023, which is required for filing for 501(c)(3) status.

Publication 557: <http://www.irs.gov/pub/irs-pdf/p557.pdf>

Form 1023: <http://www.irs.gov/pub/irs-pdf/f1023.pdf>