



501(c)(3) versus 501(c)(6) Organizations Examined

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The nonprofit sector overall continues to grow at an impressive rate. From 2003 through 2013 the nonprofit industry grew by 8.5%. That growth has not been even across the board – 501(c)(3) organizations, specifically public charities, grew almost 30% while most other types of 501(c) organizations reduced in number. Why are the number of 501(c)(3)s exploding while the rest of the sector appears to be stagnating or receding? To help put that question in context, this article covers some of the key elements of what a 501(c)(3) organization is compared to another popular 501(c) vehicle, the 501(c)(6) organization, and why it is gaining further popularity.

Core Definitions

501(c)(3)s are organized and operated primarily for religious, charitable, scientific, educational, and certain other purposes. They are what most people think of when talking about nonprofit organizations. Classic examples include Goodwill, The Salvation Army, and the Red Cross. These are organizations helping the poor, indigent, or underserved. They have classes of individuals that are organized to serve, referred to as 'charitable classes.' The primary benefit of their actions redounds to the general public. In contrast, 501(c)(6)s are business leagues or associations that are organized and operated primarily to promote the common business interests of its members. Examples include the U.S. Chamber of Commerce and the National Football League.

It is not always immediately apparent which code section a particular organization belongs to. That's because although the basic premise of these two organizations are different, they can conduct similar functions. For example, both can hold conferences and speaking events. Both can lobby, although at different levels, and both can be public advocates for issues that impact their communities. 501(c)(3)s can have the widest range of possible missions including those focused on the arts, culture, humanities, education, the environment, health care, religion and the public sector. 501(c)(6)s are focused on supporting overall industry needs, and may be involved with industries like telecommunications, food, professional and many more. They put on seminars, trade shows, write newsletters, journals, offer classes, and certification programs.

What do these organizations have in common?

Both 501(c)(3) and 501(c)(6) organizations are exempt from federal income tax, and sometimes state and local tax. Each state has its own tax code, and while most allow the federal tax exemption to drive tax treatment in their state, not all do. In order to keep their exemption, they are required to file annual information returns Form 990. Failure to file for three consecutive years results in the automatic revocation of their exempt purpose.

Both organizations are subject to the provisions of the private inurement doctrine. However, there are more substantial rules that apply only to 501(c)(3)s. These rules prevent persons with influence inside the organization from unreasonably benefiting at the expense of the nonprofit. Reasonable compensation paid for services performed is a major exception which allows nonprofits to compensate their leadership much like what would occur in the for-profit industry.

Both organizations are also subject to unrelated business income (UBI) and political activity rules. The UBI rules require nonprofits to report income earned from unrelated trade or businesses as taxable income for federal income tax purposes. They are also subject to the tax on political activities under U.S. Code §527. This tax usually pushes 501(c)(6) organizations to create separate political action committees, whereas 501(c)(3)s are unlikely to do so since they are subject to a strict prohibition on political activities.

How are they different?

The general public is largely aware that certain nonprofits provide for a tax deductible contribution. This is a major difference between 501(c)(3)s and most other 501(c) organizations as under U.S. Code §170, contributions to these entities are tax-deductible. 501(c)(3)s also have an advantage when it comes to raising funds from private foundations, which can give freely to public charities without having to do expenditure responsibility under U.S. Code §4945. Grants to any other 501(c) entity by a private foundation triggers these rules, reducing the likelihood the foundation would give to such entities.

There are a few strings attached to those privileges granted by the government. A 501(c)(3) is strictly prohibited from engaging in any political activity and are limited to the amount of lobbying they can do. Furthermore, to apply to become a 501(c)(3) in the first place, the Form 1023 application is required, which is a document that asks for a substantial amount of information about the applicant. This application serves to not only safeguard 501(c)(3) exemption but also educate new charitable organizations about the restrictions involved with operating such an entity. 501(c)(6)s have more leeway. They can choose to either file the Form 1024, a much less rigorous document, or not file an application at all and instead 'self-declare' their exempt status. Although going the self-declared route is administratively easier, which may account for why the number of non-501(c)(3) organizations are down, many organizations still prefer the benefit of official IRS recognition. Self-declared organizations also may have difficulties acquiring exemptions from state and local jurisdictions since they usually recognize IRS exempt entities only.

One final difference is how the two organizations are funded. A 501(c)(3) is supported on contributions and grants, and can have other fee for service revenue or member revenue. 501(c)(6)s are very dependent on member revenue for support as not being able to offer a tax deduction for gifts dramatically limits their ability to fundraise for contributions and grants.

How can they work together?

Many times a 501(c)(6) will create a related 501(c)(3) organization. This could be for a variety of reasons including to conduct educational or charitable endeavors or simply to access a larger network of funders. The opposite direction is much less common. Typically the parent organization will control the subsidiary via board member overlap or by having the parent be the

sole member of the subsidiary. In order to protect the exemption of both nonprofits, certain procedures need to be adopted. It's important to establish separate boards (to the extent allowable while still maintaining control), board meetings and minutes, bank accounts and recordkeeping. Staff and office sharing is accomplished with either a cost-sharing arrangement or a management services agreement. If these services are provided by the 501(c)(6) parent, they can be provided at fair value or less, and even at no cost. It is not recommended that a 501(c)(3) provide such services to a 501(c)(6) as it is easier for the 501(c)(3) to lose its tax-exemption due to conducting more than an insubstantial amount of non-exempt activities. The 501(c)(3) should make sure to be fully reimbursed at fair value for the services provided to any non-501(c)(3) entity.

What will the public support status of the 501(c)(3) be?

The related 501(c)(3) will likely be a public charity instead of a private foundation as the rules for private foundations are less conducive to working closely with a related 501(c)(6) organization. The 501(c)(3) can be publicly supported either as a 509(a)(1), (a)(2), or (a)(3) organization. 509(a)(1) organizations get their money primarily in the form of grants and contributions from the general public. (A)(2)s are less common and get their support in the form of fee for service revenue such as conferences or consulting. Finally, it is possible to have an (a)(3) supporting organization of a 501(c)(6). In order for this arrangement to work, the 501(c)(6) needs itself to pass the (a)(2) test. The benefit of setting up as an (a)(3) is that the entity doesn't need to meet the numerical public support test that (a)(2)s and (a)(1)s need to meet.

Takeaway

Although the two organizations are very different in purpose, 501(c)(3)s and 501(c)(6)s do share overlapping features and are often connected as part of a nonprofit parent-subsidary group. The 501(c)(3) has a clear advantage as far as fundraising capability, and new nonprofits should first determine if they are able to apply to be an exempt organization under this code section. It is no surprise that there are more 501(c)(3)s than ever before, as more social entrepreneurs stand poised to make use of these entities to drive their mission.

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