

ISAO SP 1000: Forming a Tax Exempt Entity

v1.0



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Forming a Tax-Exempt Entity

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ISAO Standards Organization
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1 EXECUTIVE SUMMARY

This document serves as a high-level overview of tax-exempt legal entity formation options under the Internal Revenue Code (the “Code”) for Information Sharing and Analysis Organizations (ISAOs). This document does not provide an overview of other federal taxes, non-tax considerations, or state law considerations in choosing an entity type for an ISAO.

By carefully structuring an entity under the Code, ISAO creators and managers can avoid adverse tax consequences and thereby more effectively achieve their information-sharing goals to elevate the security of the nation and those entities participating in ISAOs. This document compares and contrasts the two primary tax-exempt entity types under the Code for ISAOs: (i) business leagues and (ii) charitable organizations. It is very important that ISAO creators and managers consult with legal counsel before organizing an entity described in this document, as there are many nuances and factual circumstances that may warrant special consideration and attention.

2 TAX-EXEMPT ORGANIZATIONS

A tax-exempt organization is one that is generally not subject to federal income tax under the Code on income that is related to the organization’s exempt purpose. Entities are generally subject to federal income tax unless they satisfy the requirements for a specific exemption from taxation. States generally provide tax exemptions for entities that demonstrate that they are recognized as tax-exempt for federal purposes under the Code. Therefore, where tax-exempt status is desirable, it is important to structure an entity so that it is compliant with the federal law of tax-exempt organizations.

A key requirement of forming any tax-exempt organization is that the organization must be operated for an exempt purpose. Tax-exempt organizations recognized under the Code can be broadly divided into two categories: (1) public benefit organizations and (2) member-serving organizations. The best examples of public benefit organizations are in Section 501(c)(3) of the Code, which exempts from taxation charitable organizations that operate for a public purpose, for example, helping a charitable class such as the poor. In contrast, member-serving organizations operate to advance the interests of their members. Business leagues are an example of member-serving organizations, which do not operate to advance a public purpose but instead to more narrowly serve the interests of their members.

3 BUSINESS LEAGUES

Tax-exempt organizations formed under Section 501(c)(6) of the Code include what are often called business leagues or trade associations. Business leagues are member-serving organizations that operate to advance the interests of their members. Prominent examples of business leagues include the U.S. Chamber of

Commerce and the National Hockey League. As discussed above, business leagues are tax-exempt entities, which generally do not pay federal or state income tax on the revenue they earn in connection with their exempt purpose.

Members of a business league may also deduct as a trade or business expense the dues they pay to the business league. Because the business league pays no federal income tax on the membership dues that it receives, this provides a tax-efficient way for members with common interests to organize themselves toward a common purpose. Individuals and corporations that donate to a business league may not receive a charitable deduction for contributions made to the business league, in contrast to donations to charitable organizations. In return, however, business leagues are subject to less onerous rules under the Code than charitable organizations, and they may be operated with less administrative expense. Business leagues that have annual gross receipts in excess of \$100,000 must inform their members that membership dues are not deductible as a charitable contribution.

The primary requirements for forming and operating a business league are as follows:

- The business league must promote a common business interest among its members.
- The business league's activities should improve one or more lines of business—in other words, an industry—instead of simply performing particular services for its members.
- The business league may not engage in a regular business of a kind ordinarily carried on for profit.
- The profits of the business league may not be distributed as dividends to private individuals, in particular to insiders.
- The business league should receive funding from dues or other assessments paid by members.

In short, business leagues are an excellent option for emerging ISAOs that are looking to provide a tax-efficient method of structuring relationships between stakeholders. Unlike charitable organizations, business leagues may engage in lobbying in unlimited amounts as long as such lobbying advances the interests of the members of the business league. However, the portion of a member's dues that is used for lobbying activities is not deductible as a business expense by that member. In addition, while charitable organizations may not participate in political campaign activities at all, business leagues are permitted to engage in some degree of political campaign activities, although as with lobbying, the portion of membership dues used for political campaign activities is nondeductible.

While an ISAO that wishes to operate as a business league is not required to file an application with the Internal Revenue Service (IRS) for recognition of its federal tax exemption, it is generally good practice for a business league to do so by filing an Application for Recognition of Exemption using Form 1024. The IRS will then generally provide (based on the information provided in the Form 1024) confirmation of the business league's compliance with Section 501(c)(6), which may then be provided to members as evidence of the business league's proper formation. Like most charitable organizations, business leagues are required to file an annual information return with the IRS on Form 990, 990-EZ, or 990-N.

4 CHARITABLE ORGANIZATIONS

The primary advantage of forming a charitable organization under Section 501(c)(3) is being eligible to receive tax-deductible charitable donations from individual and corporate donors. In addition, charitable organizations can receive reduced postal rates from the U.S. Postal Service. Finally, operating as a charitable organization can often lend both credibility and prestige to an organization's activities, enabling it to have more influence than it might otherwise have if it were operating in a for-profit form. There are many examples of charitable organizations, covering a wide range of activities, including food pantries, hospitals, universities, scientific research organizations, and churches.

The primary requirements for forming and operating a charitable organization are as follows:

- The charitable organization may be organized as a nonprofit corporation, a charitable trust, or an unincorporated association. Nonprofit corporations are the most common form, and they provide additional legal protections to founders, directors, and officers.
- The charitable organization must be organized and operated exclusively for an exempt purpose, such as a charitable, scientific, or educational purpose.
- None of the charitable organization's profits may inure to the benefit of any private shareholder or individual. Reasonable compensation for services is permissible.
- The charitable organization's activities should not involve more than an insubstantial amount of lobbying activities.
- The charitable organization may not participate in any political campaign activities, such as supporting or opposing a particular candidate for public office.

As an operational matter, the above requirements for tax-exempt status as a charitable organization under Section 501(c)(3) imply that as compared to a business league, a charitable organization's activities are much more heavily regulated by the IRS. Therefore, an ISAO that wishes to retain more control over its operations may prefer to form a business league under Section 501(c)(6) rather than a charitable organization under Section 501(c)(3).

Most charitable organizations are required to file with the IRS an Application for Recognition of Exemption using Form 1023. The form generally must be filed within 27 months of the organization's formation in order for the exemption to be effective retroactively to the date of formation. Completing Form 1023 is a time-consuming but useful endeavor; the form requires the founders to provide a multi-year budget and other in-depth information on how the organization will be operated. The IRS does permit smaller charitable organizations, which anticipate having gross receipts of \$50,000 or less and assets of \$250,000 or less, to alternatively file Form 1023-EZ. Form 1023-EZ requires fewer details to be provided by the charitable organization and may result in expedited review. Finally, most charitable organizations are required to file an information return annually with the IRS on Form 990, 990-EZ, or 990-N, reporting activities for the taxable year and responding to related questions.