



ISAO SP-1000

Forming a Tax-Exempt Entity

Draft Document—Request For Comment

ISAO SO—2017 v0.01

ISAO Standards Organization

April 19, 2017

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Acknowledgements

This publication was developed by the Information Sharing and Analysis Organization Standards Organization (ISAO SO) with representatives from the private, professional, and government communities in an ongoing effort to produce a unified voluntary set of guidelines and guidance for information sharing. The ISAO SO and the Working Group leadership are listed below.

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The ISAO SO leadership would also like to acknowledge those individuals who contributed significantly in the development of these guidelines:



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1 Revision Updates

Item	Version	Description	Date

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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: (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 which may warrant special consideration and attention.

2 TAX-EXEMPT ORGANIZATIONS

A tax-exempt organization is one which 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 example of public benefit organizations is Section 501(c)(3), which exempts from taxation charitable organizations that operate for a public purpose, such as 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 any public interests, 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

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

47 Members of a business league may also deduct as a trade or business expense
48 the dues they pay to the business league. Since the business league pays no
49 federal income tax on the membership dues that it receives, this provides a tax-
50 efficient way for members with common interests to organize themselves towards
51 a common purpose. Unlike charitable organizations, individuals and corporations
52 that donate to a business league may not receive a charitable deduction for con-
53 tributions made to the business league. In return, however, business leagues are
54 subject to less onerous rules under the Code than charitable organizations, and
55 may be operated with less administrative expense. Business leagues that have
56 annual gross receipts in excess of \$100,000 must inform their members that
57 membership dues are not deductible as a charitable contribution.

58 The primary requirements for forming and operating a business league are as fol-
59 lows:

- 60 • The business league must promote a common business interest among its
61 members.
- 62 • The business league’s activities should improve one or more lines of business
63 —in other words an industry—instead of simply performing particular ser-
64 vices.
- 65 • The business league may not engage in a regular business of a kind ordinar-
66 ily carried on for profit.
- 67 • The profits of the business league may not be distributed as dividends to pri-
68 vate individuals, in particular to insiders.
- 69 • The business league should receive funding from dues or other assessments
70 paid by members.

71
72 In short, business leagues provide an excellent option for emerging ISAOs that
73 are looking to provide a tax-efficient method of structuring relationships between
74 stakeholders. Unlike charitable organizations, business leagues may engage in
75 lobbying in unlimited amounts as long as such lobbying advances the interests of
76 the members of the business league. However, portions of a member’s dues that
77 are used for lobbying activities are not deductible as a business expense by that
78 member. In addition, while charitable organizations may not participate in political
79 campaign activities at all, business leagues are permitted to engage in some de-
80 gree of political campaign activities, although as with lobbying, the portion of
81 membership dues that are used for political campaign activities are non-deducti-
82 ble.

83
84 While there is no formal requirement that an ISAO that wishes to operate as a
85 business league file an application with the Internal Revenue Service (“IRS”) for

86 recognition of its federal tax exemption, it is generally good practice for a busi-
87 ness league to do so by filing an Application for Recognition of Exemption using
88 Form 1024. The IRS will then generally provide confirmation of the business
89 league's compliance with Section 501(c)(6), which may be then provided to
90 members as evidence of the business league's proper formation. Just like most
91 charitable organizations, business leagues are required to file an annual infor-
92 mation return with the IRS on Form 990, 990-EZ, or Form 990-N.

93 **4 CHARITABLE ORGANIZATIONS**

94 The primary advantage of forming a charitable organization under Section
95 501(c)(3) is being eligible to receive tax-deductible charitable donations from indi-
96 vidual and corporate donors. In addition, charitable organizations can receive re-
97 duced postal rates from the U.S. Postal Service. Finally, operating as a charitable
98 organization can often lend both credibility and prestige to an organization's ac-
99 tivities, enabling it to have more influence than it might otherwise have if operat-
100 ing in a for-profit form. There are many examples of charitable organizations,
101 covering a wide range of activities, including food pantries, hospitals, universities,
102 scientific research organizations, and churches.

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

- 105 • The charitable organization may be organized as a nonprofit corporation, a
106 charitable trust, or an unincorporated association. Nonprofit corporations are
107 the most common form, and provide additional legal protections to founders,
108 directors, and officers.
- 109 • The charitable organization must be organized and operated exclusively for
110 an exempt purpose, such as a charitable, scientific, or educational purpose.
- 111 • None of the charitable organization's profits may inure to the benefit of any
112 private shareholder or individual. Reasonable compensation is permissible.
- 113 • The charitable organization's activities should not involve more than an insub-
114 stantial amount of lobbying activities.
- 115 • The charitable organization may not participate in any political campaign ac-
116 tivities, such as supporting a particular candidate for office.

117
118 As an operational matter, the above requirements for tax-exempt status as a
119 charitable organization under Section 501(c)(3) imply that as compared to a busi-
120 ness league, a charitable organization's activities are much more heavily regu-
121 lated by the IRS. Therefore, an ISAO that wishes to retain more control over its
122 operations may prefer to form a business league under Section 501(c)(6) rather
123 than a charitable organization under Section 501(c)(3).

124
125 Most charitable organizations are required to file with the IRS an Application for
126 Recognition of Exemption using Form 1023. The form generally must be filed
127 within 27 months of formation of the organization in order for the exemption to be
128 effective retroactively to the date of formation. Completing Form 1023 is a time-

129 consuming but rewarding endeavor; the Form requires the founders to provide a
130 multi-year budget and other in-depth information on how the organization will be
131 operated. The IRS does permit smaller charitable organizations, which anticipate
132 having gross receipts of \$50,000 or less and assets of \$250,000 or less, to alter-
133 natively file Form 1023-EZ. For 1023-EZ requires less details to be provided by
134 the charitable organization and may result in expedited review. Finally, most
135 charitable organizations are required to file an information return annually with
136 the IRS on Form 990, Form 990-EZ, or Form 990-N, reporting activities for the
137 year and responding to related questions.

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