

## **When Section 501(c)(3) Organizations Go Rogue**

by Megan L. Jones and Shani Rivaux

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In this article, Jones and Rivaux examine nonprofit organizations, from tax-exempt organizations to private foundations, and argue that governmental agencies are not doing enough to limit the defrauding of taxpayers.

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### I. What Is a 'Nonprofit' and How to Qualify

Nonprofit organizations can encompass a variety of groups, including tax-exempt organizations, charitable organizations, and private foundations. Each of these subcategories includes organizations that have qualified to be tax exempt because they meet certain criteria. As we move from the broadest — tax-exempt organizations — to the narrowest — private foundations — the rules tighten.

While nonprofits can make a profit each year, because they do not have owners, that income is not distributed to owners or shareholders but is retained inside the organization and used to

further its mission. Three basic types of nonprofit organizations exist: the unincorporated association, the charitable trust, and the nonprofit corporation.

Tax-exempt organizations are nonprofit organizations that are not subject to income tax — most typically under section 501. These include the 29 subcategories under section 501(c)(3) and others under section 501(d), (e), and (f). Section 501(c)(4) includes social welfare organizations. There are also political organizations under section 527 and homeowners' organizations under section 528. Section 501(c)(3) organizations are the most common and exempt from tax:

Corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes,<sup>1</sup> or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual, no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation (except as otherwise provided in subsection (h)), and which does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of (or in opposition to) any candidate for public office.

<sup>1</sup>Section 501(k).

Each of these organizations must be conducted as a nonprofit organization, so no part of the net earnings can inure to the benefit of a private individual or shareholder (which can be more complex than it initially seems). None of these organizations are required to pay federal income tax on what is considered their “exempt function income,” but they are subject to the unrelated business income tax under section 511 and defined in sections 512 through 514. Private foundations pay the federal excise tax on investment income under section 4940 and sometimes other private foundation taxes under sections 4941 through 4945.

To be eligible for tax-free treatment, the organization must apply for tax-exempt status with the IRS. Once recognition is granted, the organization must maintain its exempt status by completing yearly filings and meeting operational requirements. Should these conditions not be met, the organization can lose its tax-exempt status.

Further, because tax-exempt organizations are ultimately created under state law, they must meet those initial and ongoing requirements as well. Each state determines its own rules for tax-exempt entities and has its own filing and ongoing disclosure requirements.

Interestingly, “charitable” is not defined in the relevant regulations under section 501 but is addressed in section 170, which creates the income tax deduction for charitable contributions. Under section 170, charitable contributions are gifts to organizations “organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals.” The similarity of the language between the sections has arguably led to the understanding that many nonprofit organizations are also charitable organizations.

Nonprofit organizations benefit from their tax-exempt status and are given incentives under the tax code in part by not being taxed on donations made to them when those funds are used to further their mission. However, the price they pay is that no benefit can inure to an individual or individual shareholder. Moreover,

these exempt organizations can only lobby the government to a minimal degree and cannot participate in campaigns for political office. This differs from section 501(c)(4) organizations, which have more flexibility.

There are two basic types of section 501(c)(3) organizations: private foundations and those that are non-private foundations. Those controlled by one donor or a small group of donors fall under the tighter private foundation rules (sections 507 through 509). Organizations that fall under section 501(c)(3) must demonstrate that they are not private foundations.

For various public policy reasons, the tax code can encourage certain behaviors. By allowing taxpayers contributing to nonprofit organizations to get a tax deduction and the organization to be tax exempt except for unrelated business income tax, the government encourages the activities of those organizations. Nonprofit organizations often engage in activities that provide benefits beyond what the government can do.

When setting up a nonprofit, the organization itself is established under state law. It can be an unincorporated association, a charitable trust, or a nonprofit corporation.

Setting up a nonprofit corporation is similar to setting up a for-profit corporation. The entity is formed with the filing of the articles of incorporation with the relevant secretary of state, and bylaws are drafted. A board, responsible for directing the entity, is recruited. State law will define what qualifies as a nonprofit in that state. Typically, the entity cannot be set up for commercial purposes, and its purpose should be charitable. Definitions of what is charitable can vary by state, and the state’s attorney general is responsible for oversight of the nonprofit entity.

Internal oversight is provided by the board of directors, which in turn is governed by the terms of the organization’s bylaws. These bylaws are fashioned under state and sometimes case law. The board oversees the corporation and has the responsibility of ensuring that it operates according to its mission. It also oversees fundraising and the nonprofit’s management, the latter responsible for day-to-day operations. The board is bound by fiduciary duties, which require it to provide the highest level of care and to act unselfishly. These duties include a duty of care

under which directors must be reasonably informed, participate in decisions, and do so in good faith. Directors must be sensitive to conflicts and act according to the business judgment rule. They also have a duty of obedience in carrying out the entity's mission.

Once set up under state law, the entity applies for federal tax-exempt status. This application will require a mission statement, and the entity must operate to fulfill that mission to retain its tax-exempt status.

## II. IRS Tests for a Nonprofit Tax-Exempt Status

Getting and maintaining tax-exempt status is often an important goal of charitable organizations. The IRS requires the filing of Form 1023, "Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code" (or Form 1023-EZ for certain smaller organizations). Whether that status is granted will rely on whether the organization meets four tests under section 501 and the regulations — the organizational test, the operational test, the private inurement test, and the political activities test:

- *Organizational test:* This test is determined by the entity's organizational documents (such as the articles of incorporation) and all that is contained within them. To meet this test, the documents must, among other things, delineate the organization's exempt purpose. Exempt purposes are those defined as such in the IRC. The documents must also clarify that the organization will perform exempt activities and will not engage in nonexempt activities except to a minimal degree. The documents must prohibit lobbying (or can allow the entity to make an election under section 501(h) regarding the calculation of lobbying expenses). Participation in political campaigns must be prohibited, and the assets at termination must be dedicated to continuing the organization's exempt purpose.
- *Operational test:* Under this test, the organization must be operated solely for exempt purposes according to the wording under the appropriate statute (such as section 501(c)(3)). In practice, that means

that the organization must meet a "primary purpose" test in which it operates primarily for exempt purposes. Insubstantial activities can be for other purposes without the entity failing this test. Under the operational test, the IRS will sometimes look at how a similar but commercial entity is run to ensure there is a difference in operations. The organization must also operate for a public, and not private, purpose.

- *Private inurement test:* Under this test, an organization will not qualify as exempt if its net earnings inure, in part or at all, to the benefit of private individuals or shareholders. These private individuals and shareholders are the insiders of the entity, such as management and board members. The test is a functional one and looks at those who control the organization and those related to them. When there is an overlap of control and benefit, this test and requirement are likely not met.
- *Political activities test:* Under this test, two types of political activities are prohibited: lobbying and electioneering. Lobbying is the attempt to influence an election and consists of direct and grassroots lobbying. Direct lobbying consists of contacting legislators to influence their vote, while grassroots lobbying is indirect and consists of urging the public to contact legislators. Electioneering is participating in a political campaign for office, either on behalf of or against a candidate. The distinction is meaningful because most nonprofits can do limited lobbying but not electioneering. Section 501(c)(3) specifically limits organizations' activities in this area, saying that no substantial part of an organization that qualifies under its provisions can consist of propaganda or otherwise attempt to influence an election or participate in a political campaign. Section 501(c)(4) organizations can make independent expenditures for politics while concealing their donors' names, as long as politics is not the organization's primary activity.

The regulations further clarify that an action organization cannot be an exempt entity. An organization will be considered an action



organization if a substantial part of its activities involves attempting to influence an election through the use of propaganda or if it intervenes, directly or indirectly, in a political campaign. Those that are action organizations fail the political activities test.

### III. Court-Imposed Limitations on Tax-Exempt Entities

The courts also impose limits on tax-exempt entities involving illegality, public policy, and commerciality:

- **Illegality:** An organization whose activities are against the law will not qualify as a tax-exempt entity.<sup>2</sup>
- **Public policy:** An exempt organization must serve a public purpose. This requirement is imposed in addition to the operational test discussed earlier. Organizations engaging in activities that are contrary to established public policy are not serving public interests and thus do not qualify for tax-exempt status. One example is that tax-exempt schools cannot discriminate on the basis of race.<sup>3</sup>
- **Commerciality:** Organizations that operate commercially have a primary purpose that is not tax exempt and thus do not qualify for tax-exempt status. Tax-exempt entities can, however, operate and participate in commercial activities, but these activities must be in furtherance of their exempt purpose (or be minimal).<sup>4</sup>

### IV. Enforcement of the Rules

Whether nonprofit organizations have met the criteria to maintain tax-exempt status often goes unchallenged, either for lack of governmental resources or lack of motivation or for a host of other reasons. By way of illustration, charitable organizations are required to file their IRS Form 990, "Return of Organization Exempt From Income Tax," and comply with state law registration requirements. Yet there is remarkably

little oversight over the veracity of claims made in those forms and, absent an investigation, essentially no way to discern whether the solicited funds are in accordance with the charity's mission statement and representations to its donors. This has led to countless charity scams and overall distrust in the system and allows organizations to solicit funds, tax free, in the guise of charities.

Still, there are several tools that federal and state agencies (and the public) have to shine some light on misconduct committed in the name of charity. Federal and state agencies can pursue actions against nonprofit organizations that deceive the public and take advantage of the benefits allotted to truly charitable organizations. Many states also provide consumers with user-friendly methods to file complaints through simple forms on their websites or even through a helpline.

There is also a national organization, the Better Business Bureau, that sets standards and registers charities to improve the standards of governance and oversight in charitable organizations.<sup>5</sup> Its website even has a chatbot function to ask questions about charitable organizations.

### V. Enforcement Agencies and Tools

#### A. State and Federal Oversight Mechanisms

The representations necessary to obtain tax-exempt status must be adhered to in the operation of the organization. A failure to stand by the mission and promises made to the IRS (and the public) about the charitable nature of the organization can result in significant repercussions. These include the actions of the organization being enjoined, civil penalty forfeitures, restitution of monies paid, disgorgement of any ill-gotten gains, and attorney fees and costs.

The attorneys general of the states typically have authority to regulate and oversee charities and charitable solicitations in their states and are authorized to enforce their state's laws regarding the solicitation of charitable donations. This could

<sup>2</sup> See Rev. Rul. 75-384, 1975-2 C.B. 204.

<sup>3</sup> *Bob Jones University v. United States*, 461 U.S. 574 (1983).

<sup>4</sup> See *Scripture Press Foundation v. United States*, 285 F.2d 800, 802 (Ct.Cl. 1961), cert. denied, 368 U.S. 185 (1962).

<sup>5</sup> Better Business Bureau, "Charity & Donor Resources," (last accessed Oct. 23, 2024).

include actions brought under consumer protection, business regulation, charitable solicitation, or charitable trust enforcement authorities conferred by state statutes. Of particular note have been referrals by Congress to the IRS and attorneys general throughout 2024 to investigate tax-exempt organizations over their ties to terrorism, inciting violence and riots, and generally promoting unrest in various states.<sup>6</sup>

## B. The Federal Trade Commission

The Federal Trade Commission is another agency that has jurisdiction to protect consumers from fraudulent and deceptive trade practices. This includes fraudulent and deceptive marketing and advertising in connection with charitable organizations. The FTC's jurisdiction is broad through reliance on the FTC Act, 15 U.S.C. sections 41-59, and the Telemarketing Act, 15 U.S.C. sections 6101-6108. The FTC enforces section 5(a) of the FTC Act, 15 U.S.C. section 45(a), which prohibits unfair or deceptive acts or practices in or affecting commerce. The FTC also enforces the Telemarketing Act; the FTC promulgated and enforces the Telemarketing Sales Rule, 16 C.F.R. Part 310, which prohibits deceptive and abusive telemarketing acts or practices in or affecting commerce.

A lawsuit is pending that was brought by the FTC and 10 states against a charity claiming to be raising money for women battling cancer. According to the complaint, the FTC is targeting this alleged charity because "it did not operate as a legitimate charity whose primary purpose was to further its charitable mission. Instead, it was operated by [the plaintiff] primarily to benefit his own financial interests and the financial interests of the for-profit fundraisers he hired."<sup>7</sup> The FTC will often look to the organization's public-facing statements and stated mission and contrast them

with the organization's actions that are inconsistent with the representations it makes about its mission.

While the FTC has jurisdiction to go after claims on its own, it also has a website dedicated to educating the public on fraud and fraud detection.<sup>8</sup> The website even has a hotline that allows consumers to file complaints with the FTC or report scams involving consumer fraud misrepresentations.

## C. Federal and State False Claims Act

The False Claims Act, 31 U.S.C. sections 3729-3733, is used by government agencies and private individuals — that is, whistleblowers — to file lawsuits on behalf of the government and share in any recovery. In terms of reach, the False Claims Act allows enforcement actions against bad actors that are involved in schemes to defraud taxpayers, and it imposes liability on those that defraud the government or take government funds.

Under the False Claims Act, a whistleblower — or private person — who has evidence of a person or entities that defrauded the government can bring a *qui tam* action. The term "*qui tam*" refers to the Latin "*qui tam pro domino rege quam pro se ipso in hac parte sequitur*," meaning "he who brings an action for the king as well as for himself." This encourages individuals to assist the government by reporting fraud against it, which helps in recovering funds.

The False Claims Act has proven a reliable enforcement tool to recover government funds falsely obtained — including under section 501(c)(3). In 2022 the Justice Department recovered over \$1.9 billion dollars arising from *qui tam* lawsuits under the False Claims Act.<sup>9</sup> Those that helped the government expose false claims were paid a cumulative total of \$488 million, providing incentives for individuals to help uncover fraud.

The False Claims Act is not limited to federal funds. Many states have corollaries to the False Claims Act that provide similar incentives to whistleblowers.

<sup>6</sup> See, e.g., letter from James Comer, Committee on Oversight and Accountability, and Virginia Foxx, Committee on Education and the Workforce, to Treasury Secretary Janet Yellen (May 14, 2024) (requesting the information for the investigation into 20 different organizations); letter from Ways and Means Committee Chair Jason Smith to Washington Attorney General Bob Ferguson (Oct. 29, 2024); letter from Smith to New York Attorney General Letitia James (Oct. 29, 2024).

<sup>7</sup> Complaint for Permanent Injunction and Other Relief (para 42), *Federal Trade Commission and the States of California; Florida; Maryland; Massachusetts; North Carolina; Oklahoma; Oregon; Texas; Virginia; and Wisconsin v. Cancer Recovery Foundation International Inc. and Gregory B. Anderson*, 4:24-cv-008810 (Mar. 11, 2024).

<sup>8</sup> Federal Trade Commission Consumer Advice, "Charity Fraud" (last accessed Oct. 23, 2024).

<sup>9</sup> See Justice Department release on 2022 False Claims Act settlements and judgments exceeding \$2 billion (Feb. 7, 2023).

The False Claims Act imposes treble damages and penalties on those who knowingly and falsely claim money from the United States or knowingly fail to pay money owed to the United States. The False Claims Act thus serves to safeguard government programs and operations that provide access to medical care, support military and first responders, protect American businesses and workers, help build and repair infrastructure, offer disaster and other emergency relief, and provide many other critical services and benefits.

## VI. Rogue Tax-Exempts Need More Oversight and Investigations

The framework to enforce the laws concerning tax-exempt organizations depends on the states' and the federal government's ability to identify and investigate bad actors. While governmental agencies can investigate and prosecute illegal tax schemes, not enough is being done to ensure compliance, which allows wrongdoers to take advantage of the lax investigatory landscape to defraud taxpayers. These failures have led to millions of dollars passing through tax-exempt entities, such as the \$250 million COVID-19 relief scheme in Minnesota that manipulated a federal program meant to feed children during the pandemic.<sup>10</sup> The lack of oversight has also allowed hundreds of millions of dollars to flow unchecked into tax-exempt entities with alleged ties to domestic and international terrorist organizations.<sup>11</sup> These entities become a strain on the taxpayers and harm the viability of legitimate tax-exempt organizations. ■

<sup>10</sup> See the U.S. Attorney's Office for Minnesota release about defendants found guilty in \$250 million fraud scheme (June 7, 2024).

<sup>11</sup> Sam Westrop, "The U.S. Charitable Network That Subsidizes Hamas, and the Donors Behind It," *Focus on Western Islamism*, Nov. 14, 2023.

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