

Intentionally Nonprofit Journalism: A Tax Lawyer's Perspective

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With the commercial print newspaper industry faltering – 100 print newspapers including the Baltimore Examiner, the Rocky Mountain News, and Seattle Post Intelligencer closed in 2009 alone – groups of journalists are increasingly seeking alternative models to preserve a free and independent press. Some have formed nonprofits that publish exclusively on the web. This article explores the risks and rewards of groups of online journalists operating on a nonprofit, tax-exempt basis.

Although more than a dozen categories of tax exemption exist under Section 501 of the Internal Revenue Code (including labor unions, trade associations and social clubs among others), the category of tax exemption generally deemed most desirable by content publishers is Section 501(c)(3). Classification as a 501(c)(3) organization qualifies an organization to receive private foundation grants and tax-deductible contributions from individuals and businesses, as well as relieving it of the obligation to pay federal income tax on net revenues generated by its exempt operations. Section 501(c)(3) status may also enhance an organization's eligibility for government grants and, in some geographic areas, may qualify it for state and local tax exemption.

Section 501(c)(3) organizations must be organized and operated "exclusively" (which the IRS and the courts have interpreted as meaning *primarily*) for charitable purposes. Federal tax law defines the term "charitable" broadly to include objectives that are educational, religious, and scientific in nature as well as those involving the traditional notions of charity such as assisting the poor.

To enjoy the benefits of 501(c)(3) status, an organization must operate within the strict parameters of the Internal Revenue Code. In addition to operating primarily for charitable purposes, a 501(c)(3) organization may not engage in substantial lobbying activities, it may not engage in any political activity, it may not provide undue benefit to private entities or

individuals, and it may not engage to a “substantial” degree in any unrelated business activity. As discussed below, under existing law, advertising is considered an unrelated business activity for tax-exempt organizations that derive revenue from it regularly. The IRS has never explicitly defined the term “substantial.” However, it is generally believed that an activity that constitutes less than 10% of an organization’s activity is unlikely to be deemed “substantial,” while an activity that constitutes more than 25-30% of an organization’s activity will more than likely be deemed substantial. Where the line falls between the two is uncertain. The substantiality of an activity can be measured by the amount of funding devoted to it, the amount of effort the organization’s employees devote to it, or the percentage of total revenues it generates. (The difficulty of defining when the amount of “lobbying” done by a 501(c)(3) organization becomes “substantial” led Congress to enact a statute that measures substantiality for purposes of lobbying activities solely by expenditures.)

The concept of content publishers operating as 501(c)(3) organizations is not a new one, of course. For decades many of the noncommercial educational broadcasters who are affiliates of the Public Broadcasting Service and National Public Radio have been organizations with Section 501(c)(3) status individually or as a division of a college or university. Similarly, many newspapers and other print publications at institutions of higher education have derived their tax-exempt status through the institutions that house them.

Financing the Operations of a Tax-Exempt Online Newspaper

While it is certainly feasible for groups of online journalists to seek and obtain Section 501(c)(3) status, a key question that must be addressed on a preliminary basis is sources of financing. Any fan of public broadcasting is well aware that such stations rely on contributions from their supporters and air corporate “underwriting” rather than paid “advertisements.” A quick examination of federal tax law reveals why this is so.

Under Section 501(c)(3), an organization is either a private foundation or a public charity. A key difference between the two categories of organizations is the nature of their financial support. Private foundations are permitted to have a limited number of sources of financial support (for example, a single individual, family or corporation). By contrast, a public charity must generally derive either at least one-third of its financial support from the “general public” or it must operate as a “supporting organization” with respect to another publicly supported charitable organization. Public broadcasters, for example, typically operate as public charities that derive at least one-third of their support from a broad array of individuals, businesses and foundations. (As a general rule, to be counted towards “public support,” a particular contribution or grant cannot constitute more than 2% of the public charity’s total support. Accordingly, a public charity needs at least 17 contributors, although of course most public charities have many, many more than that.)

The other key difference between a private foundation and a public charity is the restrictions the Internal Revenue Code imposes upon their operations. Because a private foundation is not required to meet a public support test, it is subject to stricter rules than a public charity. For example, a private foundation is prohibited from doing business with its founder(s), substantial contributor(s), or its officers and directors with the exception that it may pay reasonable compensation to any of these “insiders” for providing personal services to the foundation. The most common type of private foundation must also distribute approximately 5% of the value of its non-charitable assets to other charities each year. The distribution requirement can be avoided if a private foundation operates as a private operating foundation. In that case, the foundation would need to expend a specified percentage of the value of its income and/or assets on its charitable operations each year. This expenditure test could presumably be fairly easily met by operating news gathering and news publication services.

Perhaps the biggest hurdle to operating as a 501(c)(3) news site is the federal tax treatment of advertising income. Advertising is considered an unrelated business activity for a 501(c)(3) organization (although, as explained below, there has been talk of creating a statutory exception to permit new organizations organized as 501(c)(3)s to sell advertising freely). In other words, net advertising income (advertising income less related expenses) is subject to federal income tax at the rates that typically would apply to a business, with a maximum tax rate of 35% currently applicable. Moreover, in addition to generating taxable income for a 501(c)(3) organization, advertising activity, if excessive, could theoretically jeopardize the organization’s tax-exempt status. For example, if an online newspaper were to generate 40% (or perhaps even 20 - 30%) of its revenue from advertising, under current law, advertising might be deemed to be a “substantial” activity of the newspaper. Because most advertising is not related to the newspaper’s exempt purpose (that is, producing and disseminating news), the newspaper could theoretically lose its tax-exempt status.

Federal tax law distinguishes between advertising and corporate sponsorship with respect to 501(c)(3) organizations. Although the line between advertising and corporate sponsorship sometimes blurs, advertising is considered promotional in nature (“Joe’s Hardware Is Best”) while corporate sponsorship, also commonly known as *underwriting*, provides non-promotional, identifying information (“Joe’s Hardware is located at 500 Main Street”). Advertising is an unrelated business activity that generates taxable net income. Because it merely identifies and does not promote, corporate sponsorship is considered benign and non-taxable.

In 2009, a bill was introduced by Senator Benjamin L. Cardin (D-MD) that would treat advertising income and subscription income received by 501(c)(3) newspapers as related, non-taxable income. The bill would also clarify that Section 501(c)(3) newspapers would not violate the proscription on participation in political campaigns through their coverage of

such campaigns. The Newspaper Revitalization Act has languished, however, amidst greater legislative attention to issues such as the global economic crisis, jobs revitalization, health care, and the wars in Afghanistan and Iraq.

Absent legislation, a 501(c)(3) journalism entity would need to ensure that its level of advertising revenue fits within the nebulous definition of “insubstantial.” Subscription income should be exempt from federal income tax even without a legislative fix, and of course a 501(c)(3) organization could receive grants, contributions, and underwriting support.

Mechanics of Establishing a Section 501(c)(3) Organization

A group that wishes to seek Section 501(c)(3) status would first incorporate at the state level as a nonprofit, nonstock corporation. A Section 501(c)(3) organization can also be established as a trust; however, we generally recommend establishing Section 501(c)(3) organizations as corporations rather than as trusts because (i) the law applicable to corporations is better-established, (ii) the standards governing corporate directors are typically somewhat less rigorous, and (iii) a subsequent change to the governing documents of a corporation is more easily accomplished.

Once the organization’s founders determine whether to organize and operate as a public charity or as a private foundation, the next step is to prepare organizational documents. Although we typically recommend that the organization be established in the state in which the founder resides, this recommendation may vary depending on the relative hospitality of that state to nonprofit organizations. For example, some states, such as Delaware and Maryland, require no separate application for state income tax exemption for an organization that has been recognized as a Section 501(c)(3) tax-exempt organization by the IRS. Other states, such as New York, have rigorous registration and reporting requirements for tax-exempt organizations.

The IRS requires that the articles of incorporation of a Section 501(c)(3) corporation state that the entity will be organized and operated exclusively for tax-exempt purposes within the meaning of Section 501(c)(3), and that no amounts other than reasonable compensation will be paid to private persons. The articles of incorporation must also state that, upon dissolution, the assets of the organization will be dedicated to exempt purposes. Certain special provisions applicable to private foundations must also be included in the articles of incorporation of a private foundation unless they appear in the governing statute of the state of incorporation.

An organization seeking Section 501(c)(3) status achieves IRS recognition of that status by filing an application on IRS Form 1023 within 27 months of the end of the month in

which the organization is formed. The application requires, among other things, that the applicant submit its organizational documents (that is, articles of incorporation and by-laws) and provide a detailed statement of its proposed activities and sources of financial support. A proposed budget for three years must be submitted. The applicant must generally submit a \$850 filing fee with the Form 1023. The average IRS processing time for Form 1023 is approximately four months.

A 501(c)(3) organization that wishes to derive financial support from contributions would be required to comply with the charitable solicitation registration requirements in the state or states in which it intends to solicit.

Corinne Antley has practiced in the field of tax-exempt organizations for more than 20 years. She represents public broadcasters, higher educational institutions and associations and other tax-exempt organizations.

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