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501(c)(3) Operational Test

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To be or stay exempt under section 501(c)(3) of the Internal Revenue Code, an organization must be operated exclusively for one or more of the exempt purposes described in section 501(c)(3) (“exempt purposes”). The first part of a compliance analysis with respect to this requirement referred to as the Operational Test is to examine whether the organization is actually operating consistent with the exempt purposes stated in its articles of organization. The second part of the compliance analysis is to examine whether it is *operating exclusively* (interpreted in the regulations to mean *operating primarily*) in furtherance of its exempt purposes.

501(c)(3) Exempt Purposes

- Religious
- Charitable
- Scientific
- Testing for public safety
- Literary
- Educational
- Prevention of cruelty to children or animals.

Operated Exclusively Means Operated Primarily

“An organization will be regarded as operated exclusively for one or more exempt purposes only if it engages primarily in activities that accomplish exempt purposes specified in section 501(c)(3). An organization will not be so regarded if more than an insubstantial part of its activities does not further an exempt purpose.

— Treasury Reg. § 1.501(c)(3)-1(c)(1)

While it's not precisely clear what "primarily" (and therefore "exclusively") means in this context, the key guidance is in the second sentence in the excerpted regulation. Only an insubstantial part of an organization's activities can further other than an exempt purpose of the organization.

That of course leaves open the question of what is "insubstantial" in this context? Unfortunately, we lack clear guidance on this issue as there are no bright line tests and the IRS has provided different types of guidance over the years regarding that factors evidence an organization's activities at issue. For example, is an organization operating primarily in furtherance of one or more exempt purposes if 90 percent of its resources are dedicated to such activities? What if the 10 percent of the organization's other activities produced 90 percent of its income?

I believe it's more about the dedication of organizational resources, including time, that is critical in the Operational Test analysis, and this seems partly supported by the Form 1023 exemption application that asks about the percentage of time allocated to each activity. However, outputs matter too. Even if 90 percent of an organization's resources were dedicated to furthering its exempt purposes, if 80 percent of the goods and services produced were not in furtherance of any of these exempt purposes, it seems certain that such organization would fail the Operational Test. This also speaks to a related test known as the Commensurate Test, which asks whether an organization's activities are commensurate in scope with its exempt purpose.

Some accountants and lawyers provide off-the-cuff advice equating the Operational Test to a test of how much income can be produced from nonexempt activities. I've heard opinions ranging from 5 percent to 30 percent of an organization's total income as being insubstantial. While the production of income from a nonexempt activity may be a factor in the Operational Test analysis, it should not be viewed as the determinative factor.

The Unrelated Business Activity Issue

If, for example, an unrelated business that does not further an exempt purpose of the organization, then such the organization can only engage in an insubstantial amount of such unrelated business activity. However, the unrelated business activity example gives rise to some confusion because there is the open issue of whether an unrelated business that is not substantially related to the organization's exempt purposes could still be engaged in to further an exempt purposes of the organization. Exempt organizations practitioners may describe this as an activity that meets the *primary purpose test* (part of the Operational Test) but not the *substantiality test* (regarding whether the business is related or unrelated). For a deeper dive into this particular issue, see [How much unrelated business activity is too much? \(https://www.thetaxadviser.com/issues/2021/jun/unrelated-business-activity-substantial-tax-exempt-organizations.html\)](https://www.thetaxadviser.com/issues/2021/jun/unrelated-business-activity-substantial-tax-exempt-organizations.html) (The Tax Adviser).

Further confusion is created by the Commerciality Doctrine, a product of the courts that looks at whether an exempt organization is operating in a manner that is too commercial to meet the Operational Test. More specifically, the Commerciality Doctrine's principal inquiry is whether the organization engaged in an activity with a substantial nonexempt commercial purpose. See [Unrelated Business Income and the Commerciality Doctrine \(https://nonprofitlawblog.com/unrelated-business-income-and-the-commerciality-doctrine/\)](https://nonprofitlawblog.com/unrelated-business-income-and-the-commerciality-doctrine/); [Commercial](#)

[Activity and the Operational Test \(https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3356958\)](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3356958) (Taxation of Exempts).

Operational Test, Private Inurement/Benefit, and Substantial Lobbying

An organization is not operated exclusively for one or more exempt purposes if its net earnings inure in whole or in part to the benefit of private shareholders or individuals. See [Private Benefit Rules – Part I: Private Benefit Doctrine \(https://nonprofitlawblog.com/private-benefit-rules-part-i-private-benefit-doctrine/\)](https://nonprofitlawblog.com/private-benefit-rules-part-i-private-benefit-doctrine/); [Private Benefit Rules – Part II: Private Inurement Doctrine \(https://nonprofitlawblog.com/private-benefit-rules-part-ii-private-inurement-doctrine/\)](https://nonprofitlawblog.com/private-benefit-rules-part-ii-private-inurement-doctrine/).

An organization is also not operated exclusively for one or more exempt purposes if it is an *action organization* (see three ways an organization can be an action organization below). But public charities should understand that a generous part of their activities focused on lobbying may not be regarded as substantial and therefore may be consistent with passing the Operational Test. See, e.g., [Public Charities Can Lobby: Guidelines for 501\(c\)\(3\) Public Charities \(https://bolderadvocacy.org/resource/public-charities-can-lobby-guidelines-for-501c3-public-charities-2/\)](https://bolderadvocacy.org/resource/public-charities-can-lobby-guidelines-for-501c3-public-charities-2/)(AFJ Bolder Advocacy); [Starting a Nonprofit: The Value of Making the 501\(h\) Lobbying Election \(https://nonprofitlawblog.com/starting-a-nonprofit-the-value-of-making-the-501h-lobbying-election/\)](https://nonprofitlawblog.com/starting-a-nonprofit-the-value-of-making-the-501h-lobbying-election/). In addition, many forms of nonprofit advocacy are permissible without limits if in furtherance of the organization's exempt purposes. See [Nonprofit Advocacy is More Than Lobbying \(https://nonprofitlawblog.com/nonprofit-advocacy-is-more-than-lobbying/\)](https://nonprofitlawblog.com/nonprofit-advocacy-is-more-than-lobbying/).

“An organization is an action organization if a substantial part of its activities is attempting to influence legislation by propaganda or otherwise. For this purpose, an organization will be regarded as attempting to influence legislation if the organization: (a) Contacts, or urges the public to contact, members of a legislative body for the purpose of proposing, supporting, or opposing legislation; or (b) Advocates the adoption or rejection of legislation.

— Treasury Reg. § 1.501(c)(3)-1(c)(3)(ii)

“An organization is an action organization if it participates or intervenes, directly or indirectly, in any political campaign on behalf of or in opposition to any candidate for public office.

— Treasury Reg. § 1.501(c)(3)-1(c)(3)(iii)

“An organization is an action organization if it has the following two characteristics: (a) Its main or primary objective or objectives (as distinguished from its incidental or secondary objectives) may be attained only by legislation or a defeat of proposed legislation; and (b) it advocates, or campaigns for, the attainment of such main or primary objective or objectives as distinguished from engaging in nonpartisan analysis, study, or research and making the results thereof available to the public. In determining whether an organization has such characteristics, all the surrounding facts and circumstances, including the articles and all activities of the organization, are to be considered.

— Treasury Reg. § 1.501(c)(3)-1(c)(3)(iv)


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