INTRODUCTION

This paper provides an overview of nonprofit organizations in Hawaii, distinguishes charitable organizations from other types of nonprofits, and describes the tax treatment that charitable organizations are provided by the federal, state, and county governments. In doing so, we hope to increase understanding of charitable organizations, which are so essential to the well-being of our communities.

FOR-PROFIT VS. NONPROFIT

While there are several different types of corporations, a basic distinction is whether a business will be for-profit or nonprofit. The incorporation of a business is done at the state level, not the federal level.¹

Nonprofit corporations are generally organized to advance a public or community interest instead of individual or personal gain. Nonprofits can make a surplus or profit, but that money must be put back into the mission of the organization. Whereas nonprofits are not allowed to distribute their earnings or pay dividends, for-profit corporations are generally operated with the goal of making money to distribute to owners or shareholders.

¹ States have their own nonprofit corporation laws; the Hawaii Nonprofit Corporation Act is found in Hawaii Revised Statutes Chapter 414D: http://www.capitol.hawaii.gov/hrscurrent/Vol08_Ch0401-0429/HRS0414D/HRS_0414D-.htm

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THE SCOPE OF NONPROFITS

Nonprofit corporations are not automatically tax exempt. Once a nonprofit corporation is established in Hawaii, exemption from federal income taxes may be sought from the Internal Revenue Service. Some, but not all, nonprofit corporations apply for and receive some form of tax exemption. A corporation’s tax status at the state and county levels is dictated by federal tax status.

When people refer to "nonprofits" that are working in the community, they are usually referring to “charitable organizations”--organizations classified under section 501(c)(3) of the federal tax code. The federal tax code, however, identifies more than 25 different tax exemptions, including: 501(c)(4) Social Welfare Organizations; 501(c)(5) Labor Unions; 501(c)(6) Chambers of Commerce; 501(c)(7) Social and Recreational Clubs; and 501(c)(13) Cemetery Companies.

Depending on the category of the tax exemption, such groups are entitled to certain privileges and subject to certain reporting and disclosure requirements and limitations on their activities.  

501(C)(3) CHARITABLE ORGANIZATIONS

The IRS has in place a rigorous process to apply for tax exemption.  To qualify as a 501(c)(3) charitable organization, the nonprofit must be organized and operated exclusively for one of the following purposes: charitable, religious,

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educational, scientific, literary, testing for public safety, fostering national or international amateur sports competition, and preventing cruelty to children or animals.\(^4\)

According to the IRS, "the term charitable is used in its generally accepted legal sense and includes relief of the poor, the distressed, or the underprivileged; advancement of religion; advancement of education or science; erecting or maintaining public buildings, monuments, or works; lessening the burdens of government; lessening neighborhood tensions; eliminating prejudice and discrimination; defending human and civil rights secured by law; and combating community deterioration and juvenile delinquency."\(^5\)

The programs of charitable organizations span a wide range of activities and causes. Charity Navigator, an independent charity evaluator, classifies organizations into broad categories such as animals, arts, culture, humanities, education, environment, health, human services, international, public benefit, and religion.\(^6\) Charitable organizations also have a wide range of business models that include generating revenues through fees for service or products, grants, and donations from public and private contributors.\(^7\)

Every exempt charitable organizations is classified as either a public charity or private foundation. Private foundations typically have a single major source of funding and most have as their primary activity the making of grants to other charitable organizations and to individuals. Private foundations are subject to substantially more restrictive rules governing their

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\(^5\) Ibid.

\(^6\) Charity Navigator’s classification system: [http://www.charitynavigator.org/index.cfm?bay=content.view&cpid=34](http://www.charitynavigator.org/index.cfm?bay=content.view&cpid=34)

operations than public charities. It is thus advantageous, where possible, to be classified as a public charity.\textsuperscript{8}

\textbf{CHARITABLE ORGANIZATIONS -- REGULATIONS AND REPORTING}

Charitable organizations are subject to various rules and reporting requirements. While the organization may earn surplus revenues, none of its earnings may inure to any private shareholder or individual. In addition, it may not attempt to influence legislation (commonly known as “lobbying”) as a substantial part of its activities, and it may not participate in any election campaign activity for or against political candidates.\textsuperscript{9} This is in contrast to some other types of tax-exempt organizations, such as 501(c)(4) organizations, which may engage in an unlimited amount of lobbying, provided that the lobbying is related to the organization’s exempt purpose, and may engage in political campaigns on behalf of or in opposition to candidates for public office provided that such intervention does not constitute the organization’s primary activity.\textsuperscript{10}

Charitable organizations are subject to significant annual reporting. At the federal level, charitable organizations must file the annual IRS Form 990, which includes extensive disclosure regarding operations and finances. Nonprofit corporations in Hawaii must additionally file an annual registration with the Department of Commerce and Consumer Affairs, and may be required to file certain periodic tax forms. In addition, charitable organizations soliciting donations in Hawaii must register with the Department of the Attorney General.\textsuperscript{11} Many charitable organizations also provide reporting and communications, above and beyond federal and state requirements, to their donors, supporters, clients, and communities.

\textbf{TAX TREATMENT OF CHARITABLE ORGANIZATIONS}

Charitable organizations receive a number of tax benefits, including exemption from certain taxes as well as the ability to raise tax-deductible donations to fund their work. Note that while they receive certain exemptions, charitable organizations are still required to pay various taxes described later in this paper.

\textbf{Brief History}

The origins of the tax-exempt sector in the United States predate the formation of a governmental framework. Early settlers formed charitable and other “voluntary”

\textsuperscript{8} \textit{Ibid.}

\textsuperscript{9} IRS -- Lobbying: \url{http://www.irs.gov/Charities-&-Non-Profits/Lobbying}

\textsuperscript{10} John Francis Reilly and Barbara A. Braig Allen, \textit{Political Campaign and Lobbying Activities of IRC 501(c)(4), (c)(5), and (c)(6) Organizations}, IRS Exempt Organizations-Technical Instruction Program for FY 2003 \url{http://www.irs.gov/pub/irs-tege/eotopicl03.pdf}.

\textsuperscript{11} Department of the Attorney General, Tax & Charities Division, Answers to Frequently Asked Questions about Hawaii’s Charity Registration Requirements: \url{http://ag.hawaii.gov/tax/files/2013/01/faqs2.pdf}
associations, such as hospitals, fire departments, schools and orphanages, to confront a wide variety of issues and ills of the era and to provide services to the public.  

In U.S. law, the original tax exemption for charitable organizations was part of the Tariff Act of 1894, which stated that “nothing herein contained shall apply to … corporations, companies, or associations organized and conducted solely for charitable, religious, or educational purposes.” When Congress enacted an income tax, in 1913, it exempted from federal income tax “any corporation or association organized and operated exclusively for religious, charitable, scientific, or educational purposes, no part of the net income of which inures to the benefit of any private shareholder or individual.” This exemption endures today in the form of section 501(c)(3) of the tax code.

Federal Taxes

At the federal level, tax-exempt organizations are not taxed on income from activities that are substantially related to their charitable, educational, or other exempt purposes. Such income may be exempt even if the activity is a trade or business. Tax-exempt organizations are also exempt from tax on certain capital gains, dividends, and other passive sources of income.

Further, contributions made to charitable organizations by individuals and corporations are deductible for tax filers who itemize deductions under section 170 of the Internal Revenue Code.

State of Hawaii – Income Tax

The State of Hawaii follows the IRS’s income tax treatment of a nonprofit organization that has secured federal 501(c)(3) tax-exempt status.

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13 Ibid.
Hawaii taxpayers may include charitable contributions in itemized deductions for state income tax purposes.\(^{17}\)

**State of Hawaii – General Excise Tax**

In Hawaii, businesses are subject to the General Excise Tax, a gross income tax imposed on receipts from almost all business activities. Taxable activities include wholesale and retail sales of personal tangible property, the provision of services, the receipt of commissions, and leasing and rental activities. The GET is applied before most business deductions and may thus apply even where a transaction does not result in net profit. Certain organizations, including "corporations, associations, trusts, or societies organized and operate exclusively for religious, charitable, scientific, or educational purposes" may receive an exemption from the GET for certain activities. The exemption permits the organization to receive revenues from these specific activities tax-free.\(^{18}\)

Despite this exemption, charitable organizations are still subject to the GET when it comes to fundraising revenues -- revenues from activities whose primary purpose is the production of income, even if the income is ultimately used in furtherance of exempt activities. In general, "fundraising activities" are activities conducted with the intention of generating income, and are outside of the organization's stated exempt purpose.\(^{19}\)

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\(^{17}\) In the face of budget challenges in 2011, Act 97 was enacted to limit itemized deductions, including charitable contributions for certain taxpayers. See Department of Taxation Announcement No. 2011-20: http://www6.hawaii.gov/tax/announce/ann11-20.pdf. Two years later, the legislature reversed this policy with respect to charitable contributions by passing House Bill 430. This bill exempted charitable contributions from the limits on itemized deductions and successfully restored the full incentive for charitable giving. Governor Abercrombie signed House Bill 430 into law on July 2, 2013.

\(^{18}\) Haw. Rev. Stat. § 237-23(4). Nonprofits that are tax exempt under subsections (c)(4), (c)(6), and (c)(8) of the Internal Revenue Code may also receive a GET exemption.

Counties – Real Property Taxes

In the four counties in Hawaii, real property used exclusively for charitable purposes is generally exempt from real property taxes.\textsuperscript{20}

TAXES FROM WHICH CHARITABLE ORGANIZATIONS ARE NOT EXEMPT

GET - Fundraising revenues

As explained above, charitable organizations’ fundraising activities are subject to GET.

GET - Goods and services purchased

A nonprofit organization’s receipt of a GET exemption does not excuse the organization from paying taxes when it purchases goods or services.\textsuperscript{21}

Use taxes

Nonprofit organizations that have properly registered for exemption from the GET do not receive a corresponding exemption for Hawaii’s use tax law. The use tax requires customers who purchase goods from out of state sellers to pay a tax on that purchase at the same rate that an in-state seller would have paid in GET if the sale had occurred in Hawaii.\textsuperscript{22}

Unrelated Business Income Tax

If an exempt organization regularly carries on a trade or business not substantially related to its exempt purpose, the organization is subject to federal tax on its income from that unrelated trade or business.\textsuperscript{23} Hawaii follows the federal determination of unrelated business income for Hawaii income tax purposes.\textsuperscript{24}

\textsuperscript{20} Number and Amount of Exemptions by Type and County for Fiscal Year 2012-13: https://www.realpropertyhonolulu.com/content/rpadcms/documents/2012/12_ex.pdf


\textsuperscript{23} Publication 598 (03/2012), Tax on Unrelated Business Income of Exempt Organizations: http://www.irs.gov/publications/p598/index.html

Employment taxes

Tax-exempt organizations have important responsibilities as employers while operating and managing their activities.

If the organization has employees, it is required to pay several federal, state, and local taxes. As an employer, the organization must withhold certain taxes from employees’ paychecks. Employment taxes include the following: Federal income tax withholding (FITW), State income tax withholding, Social Security and Medicare taxes (FICA), and Federal unemployment taxes (FUTA). Nonprofits also pay for State Unemployment Insurance if they choose to be covered by the State.25

All employers in Hawaii with one or more employees--full-time or part-time, permanent or temporary--are required to provide Workers' Compensation and Prepaid Health Care coverage for the employees, as well as Temporary Disability Insurance or sick leave benefits when their employees are unable to work because of a non-work-related illness or injury.26

CONCLUSION

In Hawaii and elsewhere, nonprofit organizations participate in a wide range of activities, services, and business models. Rooted in a long history of recognition by government, charitable organizations receive important tax benefits to acknowledge their significant benefit to the community. Although charitable organizations have certain tax exemptions, they are still subject to a number of taxes related to their activities, as well as extensive regulation and reporting requirements.

Recommended Resources

- Hawaii Alliance of Nonprofit Organizations http://hano-hawaii.org/
- Hawaii Community Foundation http://www.hawaiicommunityfoundation.org/
- National Council of Nonprofits http://www.councilofnonprofits.org/
- IRS Tax Info for Charities & Other Nonprofits http://www.irs.gov/Charities-&-Non-Profits
- The National Center for Charitable Statistics http://nccs.urban.org/
- The Center for Civil Society Studies http://ccss.jhu.edu/
- BoardSource https://www.boardsource.org/
- GuideStar http://www.guidestar.org/
- Foundation Center http://foundationcenter.org/
- Independent Sector http://www.independentsector.org/
- Blue Avocado http://www.blueavocado.org/