

HOW TO LOSE YOUR 501(C)(3) TAX EXEMPT STATUS (Without Really Trying)

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Overview

- Basics of Tax Exempt Status
- The Importance of 501(c)(3) Status
- Top Ways to Lose Your Status, and How to Avoid Them
- Tips for Maintaining Your Status



BASICS OF TAX EXEMPT STATUS

Why?

- Congress—some organizations should put all funds toward their great work



Types of Tax Exemption

- 501(c)(3) – charitable, educational and religious organizations
- 501(c)(4) – social welfare organizations
- 501(c)(5) – agricultural organizations
- 501(c)(6) – trade associations, professional societies & chambers of commerce



Exemption From ALL Taxes?



- No—only federal corporate income tax
- Must be *substantially related* to the purposes of the organization



Tax Exempt Purposes

- Charitable
- Religious
- Educational
- Scientific
- Literary
- Testing for public safety
- Fostering amateur sporting
- Preventing cruelty to animals



THE IMPORTANCE OF 501(C)(3) STATUS

Accepting Tax Deductible Contributions

- **Organize the approach to seeking private contributions**
 - Obtain state and federal exemption status
- **Provide tax write-offs for contributors**
 - Individuals
 - Corporations



Special Grants and Rates

- Many organizations offer discounts and special rates to nonprofits
- Eligible for grants from foundations and other organizations



Independence & Limited Liability

- Nonprofits with tax exempt status are **independent** from their creator
- Liability is limited to the assets of the organization itself



WAYS TO LOSE TAX EXEMPT STATUS

(And, how to avoid them)

FRAUD & THE MISUSE OF ASSETS

The Basics of Fraud

- The occurrence of fraud cannot be altogether eliminated
- Effective controls and safeguards are important risk management tools
 - ▣ Include “after action review”

Internal vs. External Frauds

Internal

- Asset misappropriation
 - ▣ Cash
 - ▣ Non-cash
- Corruption
- Fraudulent Reporting
- Employee identity theft

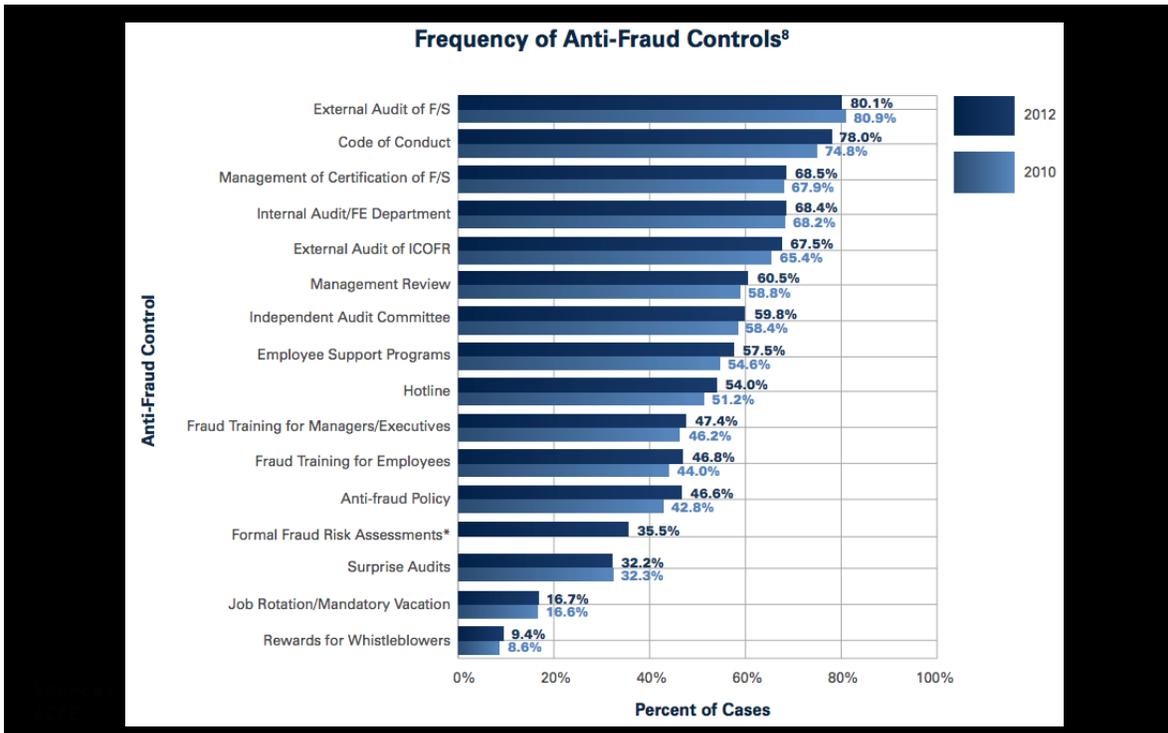
External

- Internet based schemes
- Vendor/ staff collusion
- Donor, client or member identity theft

Dangerous Assumptions about Fraud



- Most frauds are perpetrated by bookkeepers or accountants
- An independent audit is the best way to detect fraud



Perpetrators of Fraud

- ❑ **Perpetrators with higher levels of authority cause much larger losses**
- ❑ The median loss of frauds committed by:
 - ❑ Executives = **\$600,000**
 - ❑ Managers = **\$85,000**
 - ❑ Employees = **\$65,000**



What does it look like?

Minnesota sues Eden Prairie nonprofit for diverting money meant for low-income students

State suit against Eden Prairie education nonprofit says its director diverted hundreds of thousands of dollars to himself.

By Kelly Smith Star Tribune | MARCH 14, 2014 — 11:57AM

JULY 11, 2014

Couple Admits Looting \$1.4-Million From Ky. Charity

The former chairman of a Louisville, Ky., education foundation and his wife pleaded guilty Thursday to stealing \$1.4-million from the charity, virtually wiping out its assets, *The Courier-Journal* reports.

Charles Muir, 61, and Diana Muir, 60, admitted to money laundering and fraud-related charges. Under a plea bargain, they agreed to prison terms

PROTECTING YOUR ASSETS

- **Have checks and balances**
 - Split financial responsibilities
 - Have an independent review
 - Provide appropriate access to the funds

Private Benefit or Inurement

- Private Benefit
 - ▣ Nonprofit operations must serve an exempt purpose
 - ▣ Serve *public interest* not private
- Inurement
 - ▣ insiders are not benefited by the income or assets of the organization



EXAMPLE: Private Benefit

- An organization with one staff member, the president
- Board was him, his wife, and his father
- President took loans for private purposes
- He used nonprofit credit for personal expenses
- The IRS revoked the 501(c)(3) status



Lobbying

- Lobbying must be insubstantial
- This includes contacting or urging the public to contact legislative bodies
- IRS may apply an *expenditure test* to determine how substantial the activity is



Expenditure Test

If the amount of exempt purpose expenditures is:	Lobbying nontaxable amount is:
≤ \$500,000	20% of the exempt purpose expenditures
>\$500,00 but ≤ \$1,000,000	\$100,000 plus 15% of the excess of exempt purpose expenditures over \$500,000
> \$1,000,000 but ≤ \$1,500,000	\$175,000 plus 10% of the excess of exempt purpose expenditures over \$1,000,000
>\$1,500,000	\$225,000 plus 5% of the exempt purpose expenditures over \$1,500,000



Political Activity

- 501(c)(3)s cannot participate or intervene in campaigns or on behalf of candidates
 - Monetary contributions
 - Public statements of position
- Can generally promote voting



Nonprofits' failure to report political activity to IRS raises questions

Organizations 'playing with fire' says tax attorney

By Julie Patel 6:00 am, February 27, 2014 Updated: 5:27 pm, July 28, 2014

45 likes 31 tweets Comment E-mail Print

A **Center for Public Integrity** analysis of dozens of Internal Revenue Service and Federal Election Commission documents found three social welfare nonprofits that spent money on politics and did not report their activity to the Internal Revenue Service, as required.

"That's called playing with fire," Marcus Owens, a former chief of the IRS's nonprofits division, said about groups that neglect to report political expenses.



The Internal Revenue Service building in Washington Susan Walsh/AP



Unrelated Business Income (UBI)

- Income from a business unrelated to the stated exempt purposes of a nonprofit are taxable
- Referred to as UBIT



Unrelated Business Income (UBI)

- 3-part test:
 - ▣ (1) trade or business
 - ▣ (2) regularly carried on
 - ▣ (3) not substantially related to the stated exempt purpose

Unrelated Business Income (UBI)

- Common examples:
 - sale of ad space
 - sale of unrelated merchandise or publications
 - providing management to other organizations



Is it Unrelated Business Income (UBI)?

- A community pool charges an entry fee
- The nonprofit's purpose is to promote sporting and educate patrons about water safety
- Once a month, the pool hosts a swim meet where anyone can pay \$10 to participate



Is it UBI?

- Trade or business? YES
- Regularly carried on? YES
- Unrelated to purpose? NO



Is it Unrelated Business Income (UBI)?

- An after-school program with the purpose of serving local children owns a vacant lot
- CEO builds a convenience store in the lot to support the purpose of the nonprofit
- The store provides significant monies for the nonprofit to continue its services



Is it UBI?

- Trade or business? YES
- Regularly carried on? YES
- Unrelated to purpose? YES



Annual Reporting Obligation

- reporting duties to ensure continued tax-exempt status
- Form 990

Form 990		Return of Organization Exempt From Income Tax		OMB No. 1545-0047
Department of the Treasury Internal Revenue Service		Under section 501(c), 527, or 4947(a)(1) of the Internal Revenue Code (except private foundations)		2014
		Do not enter social security numbers on this form as it may be made public.		Open to Public Inspection
		Information about Form 990 and its instructions is at www.irs.gov/form990 .		
A For the 2014 calendar year, or tax year beginning		, 2014, and ending		, 20
<input type="checkbox"/> Address change	<input type="checkbox"/> Doing business as		<input type="checkbox"/> Employer identification number	
<input type="checkbox"/> Name change	Number and street (or P.O. box if mail is not delivered to street address) Room/suite		<input type="checkbox"/> Telephone number	
<input type="checkbox"/> Initial return	City or town, state or province, country, and ZIP or foreign postal code		<input type="checkbox"/> Gross receipts \$	
<input type="checkbox"/> Final return/terminated	Amended return		<input type="checkbox"/> Yes <input type="checkbox"/> No	
<input type="checkbox"/> Application pending	F Name and address of principal officer:		H(j) Is this a group return for subsidiaries? <input type="checkbox"/> Yes <input type="checkbox"/> No	
<input type="checkbox"/> Tax-exempt status:	501(c)(3) 507(j) (insert no.) 4947(a)(1) or 527		H(b) Are all subsidiaries included? <input type="checkbox"/> Yes <input type="checkbox"/> No	
J Website:		H(e) Group exemption number		
K Form of organization: <input type="checkbox"/> Corporation <input type="checkbox"/> Trust <input type="checkbox"/> Association <input type="checkbox"/> Other		L Year of formation:		M State of legal domicile:
Part I Summary				
1 Briefly describe the organization's mission or most significant activities:				
2 Check this box <input type="checkbox"/> if the organization discontinued its operations or disposed of more than 25% of its net assets.				
3 Number of voting members of the governing body (Part VI, line 1a)				3
4 Number of independent voting members of the governing body (Part VI, line 1b)				4
5 Total number of individuals employed in calendar year 2014 (Part V, line 2a)				5
6 Total number of volunteers (estimate if necessary)				6
7a Total unrelated business revenue from Part VIII, column (C), line 12				7a
b Net unrelated business taxable income from Form 990-T, line 34				7b

What do I need to file?

Which forms do exempt organizations file?

Most tax-exempt organizations are required to file an [annual return](#). Which form an organization must file [generally](#) depends on its financial activity, as indicated in the chart below.

Status	Form to File	Instructions
Gross receipts normally \leq \$50,000 Note: Organizations eligible to file the <i>e-Postcard</i> may choose to file a full return	990-N	n/a
Gross receipts < \$200,000, and Total assets < \$500,000	990-EZ or 990	Instructions
Gross receipts \geq \$200,000, or Total assets \geq \$500,000	990	Instructions
Private foundation - regardless of financial status	990-PF	Instructions



Operating for Non-Exempt Purposes



- Organization stops doing *all* or a *significant amount* of the exempt activities stated in the original application for exemption



What if our purpose has changed?

- Tell the IRS
- Ask for a *determination letter*
- If you're unsure, ask for a *private letter ruling*



TIPS FOR MAINTAINING YOUR STATUS

Tips

- Make sure you file your 990 with the IRS
- Provide donors with a written receipt
- Register for charitable solicitation in every state where you do fundraising



Tips



- Use process to choose vendors & events
- Understand and avoid lobbying activities
- Avoid political campaign activity



Tips

- Pay taxes on any unrelated business income generated by your nonprofit
- **Get legal help!** If you're in doubt about your activities, make sure that you're playing it safe



Practical Resources

Subscriptions Language Information For...
 Search Advanced

Filing Payments Refunds Credits & Deductions News & Events Forms & Pubs Help & Resources for Tax Pros

Charities & Non-Profits

Charitable Organizations
 Churches & Religious Organizations
 Political Organizations
 Private Foundations
 Other Non-Profits
 Contributors

Tax Information for Charities & Other Non-Profits

- Applying for Tax Exempt Status**
Information about how to apply for IRS recognition of tax-exempt status.
- Annual Reporting & Filing**
990-series forms, requirements, and filing tips
- Revoked? Reinstated? Learn More**
Information about the automatic revocation process and how to be reinstated.
- EO Select Check**
Search for a tax-exempt's status.
- Educational Products, Workshops and Seminars for Exempt Organizations**
IRS programs and materials for non-profit organizations.
- How to Stay Exempt**
Resources for tax-exempt nonprofit organizations.
- StayExempt.IRS.gov**
Tax basics for exempt organizations

News

- ACT releases 2015 report
- Disclosure of National Office Determination Letters
- Form 1023-EZ Update
- TE/GE FY 15 Program Letter
- Charting Path Forward - April 24 Update
- Streamlined Option for Some (c)(4)s
- Changes to the EO Determinations' Additional Information Request Process Beginning September 2015

Charities & Non-Profits Topics

- A-Z Index
- Search for Charities
- Calendar of Events
- Charity and Nonprofit Audits
- Free e-Newsletter
- Online Training
- Life Cycle
- Taxpayer Bill of Rights
- Tax Exempt and



www.stayexempt.irs.gov

Thank You!

 **Nonprofit Risk Management Center**
Find the answer here | nonprofitrisk.org

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