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How to Lose your 501(c)(3) Tax Exempt Status (Without Really Trying)

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The most common type of US tax-exempt nonprofit organization falls under category 501(c)(3), whereby a nonprofit organization is exempt from Federal income tax if its activities have the following purposes: charitable, religious, educational, scientific, literary, testing for public safety, fostering amateur sports competition, or preventing cruelty to children or animals.

In order for an organization to maintain their tax exempt status, they must pay close attention to rules in these six important areas:

- Private benefit/inurement;
- Lobbying;
- Political campaign activity;
- Unrelated business income (UBI);
- Annual reporting obligation; and
- Operation in accord with stated exempt purpose(s).

An organizations failure to adhere to the rules with regard to these areas may result in loss of their exempt status.

Each year, the Internal Revenue Service (IRS) revokes the tax-exempt status of more than 100 501(c)(3) organizations.

Private Benefit/Inurement

Private Benefit: A 501(c)(3) organization's activities should be directed exclusively toward some exempt purpose. Its activities should not serve the private interests, or private benefit, of any individual or organization (other than the 501(c)(3) organization) more than insubstantially. The intent of a 501(c)(3) organization is to ensure it serves a public interest, not a private one.

- A nonprofit organization must serve the public good. Profits (and it is a myth that nonprofits can't have these) are not paid to individuals but channeled back into the organization's activities.
- However, you can pay reasonable salaries to your staff.

Private Benefit/Inurement (con't.)

Inurement: The concept of inurement states that no part of an organization's net earnings may inure to the benefit of a private shareholder or individual who, because of the person's relationship to the organization, has an opportunity to control or influence its activities.

- This requirement is "absolute" which means that any such payment or sale could result in the IRS stripping your exempt status and the insiders involved could be subject to penalty excise taxes.

Private Benefit/Inurement (con't.)

- Prohibited inurement includes the payment of dividends, the payment of unreasonable compensation to insiders, and the transfer of property to insiders for less than fair market value.

If a 501(c)(3) organization engages in inurement or substantial private benefit, the organization risks losing its exemption. Additionally, insiders guilty of inurement may be subject to excise tax.

Political activities and legislative activities (commonly referred to as lobbying) are two different things and are subject to two different sets of rules and have different consequences of exceeding the limitations.

Lobbying (Legislative Activities)

- In general, no organization may qualify for Section 501(c)(3) status if a substantial part of its activities is attempting to influence legislation (commonly known as *lobbying*). A 501(c)(3) organization may engage in some lobbying, but too much lobbying activity risks loss of tax-exempt status.
- What is lobbying: It is when an organization contacts, or urges the public to contact, members or employees of a legislative body for the purpose of proposing, supporting, or opposing legislation, or when the organization advocates the adoption or rejection of legislation, it is lobbying.

Lobbying (Legislative Activities) (con't.)

- While a 501(c)(3) organization is allowed to do some lobbying, too much can hurt its tax-exempt status. Its lobbying activities cannot be more than an insubstantial part of its overall activities.
- Organizations may, however, involve themselves in issues of public policy without the activity being considered as lobbying. For example, organizations may conduct educational meetings, prepare and distribute educational materials, or otherwise consider public policy issues in an educational manner without jeopardizing their tax-exempt status.

Lobbying (Legislative Activities) (con't.)

- What is permissible lobbying: Lobbying is permissible, provided it is not a substantial part of an organization's activities. Whether a specific activity (or group of activities) of an organization is a substantial portion of its total activities depends on the facts involved.
- Internal Revenue Code (IRC) Section 501(h) establishes more precise standards for determining whether a Section 501(c)(3) organization's legislative activities are substantial. Eligible organizations that make the lobbying election can spend a specified amount to influence legislation without risking the organization's tax exemption. Amounts exceeding the prescribed limitation are subject to a 25 percent excise tax (IRC Section 4911). In addition, if the electing organization's lobbying expenditures normally exceed 150 percent of the prescribed amount, its exempt status will be revoked.

Political Activity

- "Political activity" is not defined in the law regulating tax-exempt organizations with any more detail than that in IRC 501(c)(3), where it is:
 - "Participating in, or intervening in (including the publishing or distributing of statements), any political campaign on behalf of (or in opposition to) any candidate for public office."
- The prohibition applies to all campaigns (Federal, state, and local level). Political campaign intervention includes any and all activities that favor or oppose one or more candidates for public office.

Political Activity (con't.)

- A 501(c)(3) tax-exempt organizations may lose their tax-exempt recognition for any political activity, and not just for making political expenditures. The term "political expenditure" means any amount paid or incurred by a Section 501(c)(3) organization in any participation in, or intervention in (including the publication or distribution of statements), any political campaign on behalf of (or in opposition to) any candidate for public office.

Political Activity (con't.)

- Contributions to political campaign funds or public statements of position (verbal or written) made by or on behalf of an organization in favor of, or in opposition to, any candidate for public office clearly violate the prohibition on political campaign intervention.
- IRC 501(c)(3) organizations that engage in any political activity may, at the discretion of the IRS, either immediately lose their tax-exempt status recognition, or be compelled to pay fines. These take the form of excise taxes, described in IRC 4955, levied against both the organization itself and the organization managers responsible for the illegal activity.

Unrelated Business Income (UBI)

- Another activity that can potentially jeopardize an organization's 501(c)(3) tax-exempt status is having too much income generated from activities that are unrelated to the exempt function of the organization.
- This income comes from a regularly carried-on trade or business that is not substantially related to the organization's exempt purpose. An organization that produces unrelated business income as a result of its unrelated trade or business may have to pay taxes on that income (Form 990-T).

Unrelated Business Income (UBI) (con't.)

- An income producing activity must meet three conditions before the income is potentially taxable:
 - First, the activity must be a trade or business.
 - Second, the trade or business must be regularly carried on.
 - Third, the business activity is not substantially related to an organization's exempt purpose. In other words, the activity itself does not contribute importantly to accomplishing the exempt purpose, other than through the production of funds.

Unrelated Business Income (UBI) (con't.)

- Some of the most common UBI generating activities include:
 - The sale of advertising space in weekly bulletins, magazines, journals, or on the organization's website;
 - The sale of merchandise and publications when those items being sold do not have a substantial relationship to the exempt purpose of the organization;
 - Provision of management or other similar services to other organizations; and

Unrelated Business Income (UBI) (con't.)

- Even some types of fundraising activities.
- In addition to the taxability of income generated from unrelated activities, if those activities are substantial in relation to your exempt purpose activities, you may be putting your exempt status in jeopardy.

Annual Reporting Obligation

- While 501(c)(3) public charities are exempt from Federal income tax, most of these organizations have information reporting obligations under the IRC to ensure they continue to be recognized as tax-exempt.
- Public charities generally file either:
 - Form 990, Return of Organization Exempt from Income Tax;
 - Form 990- EZ, Short Form Return of Organization Exempt from Income Tax; or
 - Submit online Form 990-N, Electronic Notice (e-Postcard) for Tax-Exempt Organizations not Required to File Form 990 or 990-EZ.

Annual Reporting Obligation (con't.)

- The type of form or notice required is generally determined by the public charity's gross receipts and the value of its assets.
- In addition, they may also be liable for unrelated business income tax as described above, employment tax, excise taxes, and certain state and local taxes.
- Some public charities that are not required to file Forms 990 or 990-EZ, including churches and certain church-affiliated organizations.

Annual Reporting Obligation (con't.)

- Provisions of the Pension Protection Act of 2006, required that all tax-exempt organizations, except churches and church-related organizations, must file an annual return with the IRS and if they do not do so for three consecutive years, they automatically lose their exempt status.
- If an organization finds that its exempt status has been automatically revoked due to non-filing and it wants its tax-exempt status reinstated, it will need to reapply and pay the appropriate user fee.

Annual Reporting Obligation (con't.)

- In 2011, the IRS announced that approximately 275,000 organizations under the law had automatically lost their tax-exempt status because they did not file legally required annual reports for three consecutive years. The IRS believed the vast majority of those organizations were defunct, it also announced special steps to help any existing organizations to apply for reinstatement of their tax-exempt status.

Operation in Accord with Stated Exempt Purpose(s)

If an organization stops doing all or a significant amount of the exempt activities under the premise it was formed in, its original application (IRS Form 1023 series) could lose its exemption.

- The exempt purpose should be embodied in a mission statement, which may be found in an organization's bylaws and its articles of incorporation.
- Your mission statement should be revisited periodically to see if it still works for your organization.

Operation in Accord with Stated Exempt Purpose(s) (con't.)

- It is also imperative that you reconsider the mission statement as part of any new planning you may do, such as putting together a strategic plan.
- Many times, organizations "morph" as the realities of actually operating sink in, or as the external environment changes.

Operation in Accord with Stated Exempt Purpose(s) (con't.)

- Depending on the degree of changes your original mission statement may need to be tweaked or even completely rewritten, depending on the circumstances.
- Amendments to an organization's mission statement will usually not jeopardize the organization's 501(c)(3) tax-exempt status, so long as the mission statement remains consistent with a tax-exempt purpose and the change is disclosed to the IRS on Form 990 or 990-EZ, along with the amended organizational document.
- If the organization is not required to file an annual return, it may report the change to the EO (Exempt Organizations) Determinations Office.

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