

Activities that Can Risk an Organization's Tax Exempt Status

It seems like almost every year I can count on receiving one or more inquiries from a nonprofit about letting someone use their organization's tax identification number or wanting the nonprofit to serve as the "fiscal sponsor" for their activity during an interim period while they complete their own incorporation and tax exemption application process. And every time I tell them the same thing. "Your nonprofit was granted an exemption to pursue your exempt purposes only. Your exemption is not transferable to others or available to help fulfill their purposes, no matter how worthy it might be." This is a non-negotiable position with the Internal Revenue Service (IRS). And the failure of nonprofits to understand and recognize this is one of several reasons why they can sometimes put themselves in a position to lose their tax exempt status.

While it is fairly easy for a nonprofit to obtain, and then maintain, its tax exempt status it can also be just as easy to lose it if you are not careful. Each year, the IRS revokes the tax-exempt status of about 100 or so organizations organized under section 501(c)(3) of the tax code. Organizations recognized as exempt from federal income tax under this section of the tax code include churches, other religious organizations, educational institutions, hospitals, and many other types of public charities, including private foundations.

But these organizations can only expect to maintain their tax-exempt status if they follow the rules and heed their activities in the following areas:

- Private benefit/inurement
- Lobbying
- Political campaign activity
- Unrelated business income (UBI)
- Annual reporting obligation

1. Operating in accordance with your stated exempt purpose(s)

Your exemption was granted based upon what you told the IRS you were going to do. Your ability to maintain that exemption will be dependent upon only operating within the bounds of your stated purpose and not allowing your activities to be high jacked by others, either inside or outside the organization for their purposes. If you stop doing all or a significant amount of the exempt activities you told the IRS you were going to do in your original application for exemption—you could lose your exemption. Sure, sometime your direction may need to change, or you may wish to expand the nature of your activities to include other exempt purposes. But you cannot simply begin operations in these areas without first consulting with the IRS about it. Many churches I have come in contact with tend to assume that they are too small for the IRS to be concerned with, or the IRS will never find out about their activities. But eventually they will. And when they do the consequences can be severe.

2. Private benefit/inurement

Private benefit: A 501(c)(3) organization's activities should be directed exclusively toward some previous approved exempt purpose and should never serve the private interests, or private benefit, of any individual or organization (and where it does, say in the case of providing housing for pastors on staff, it's primary benefit must be for the church and any personal benefit may not be substantial in nature and may need to be reported.) The intent of a 501(c)(3) organization is to ensure it serves a public interest, not a private one.

Inurement: The concept of inurement means 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. All 501(c)(3) organizations are prohibited from allowing its income or assets to benefit insiders (people with a personal or private interest in the activities of the organization. The IRS considers insiders to be; board members, officers, directors, and key employees in a position to influence the decisions of the organization. Prohibited inurement includes the payment of unwarranted bonuses or dividends, the payment of unreasonable compensation, and/or the transfer of property to insiders for less than fair market value.

If a 501(c)(3) type organization engages in inurement or substantial private benefit, the organization will risk loss of exempt status. Additionally, individuals guilty of inurement may be subject to intermediate sanctions and taxes under the "excess benefit rules."¹

3. Lobbying

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. 501(c)(3) type organizations are allowed to do some lobbying, however, if lobbying activities are substantial in nature, an organization will risk losing its tax exempt status. What is "substantial" in the eyes of the IRS? Unfortunately, there is no definition under the law. There are tests the IRS has set up to help nonprofits determine whether or not the activities are substantial.² And organizations can actually make an election (501(h)) to not spend more than a certain percentage of its total expenses on lobbying activities. Or they can use the more subjective test which evaluates all of the pertinent facts and circumstances of an organization's lobbying activities to make a determination. But in any case such activities need to be secondary to the exempt purposes of the organization if you are to protect your exemption from income tax.

4. Political Activity

All section 501(c)(3) organizations are prohibited from directly or indirectly participating in, or intervening in, any political campaign on behalf of (or in opposition to) any candidate running

¹ <https://www.irs.gov/charities-non-profits/charitable-organizations/intermediate-sanctions-excess-benefit-transactions>

² <http://www.nolo.com/legal-encyclopedia/how-much-lobbying-can-nonprofit-do.html>

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. The prohibition extends beyond candidate endorsements and can include contributions to political campaign funds and/or public statements of position on behalf of a candidate for public office.

There are no prohibitions on section 501(c)(3) organizations to promote voter registration, encourage voter participation, and/or provide voter education. But they can't engage in activities that favor or oppose any one candidate for public office. The prohibition is designed to prohibit these leaders from making partisan comments in official organization publications or at official functions of the organization where they could be construed as being the official position of the nonprofit on the candidate.

The IRS will tell you that the political campaign intervention prohibition is not intended to restrict free expression on political matters by leaders of nonprofit organizations. Speaking for themselves as individuals about important issues of public policy is a right afforded all individuals under the constitution. You just can't use the platform of the nonprofit to promote those views.

One final note on this, the insubstantial rules that can be applied to lobbying activities do not apply to speaking out in favor or one candidate or another. This is a strict prohibition against any activity at all.

5. Unrelated Business Income (UBI)

Another activity that can potentially jeopardize an organization's tax-exempt status is having too much income generated from activities that are unrelated to the exempt function of the organization. An organization that produces unrelated business income as a result of its activities may have to report the activities and pay taxes on net income produced.

Income-producing activity must meet three conditions before potentially being taxable. First, the activity must meet the definition of being a trade or business. Second, the trade or business must be regularly carried on. Third, the business activity must be demonstrated as being not substantially related to the organization's exempt purpose (e.g. does the activity contribute importantly to accomplishing the exempt purpose of the organization, other than through the production of funds).

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.
- Sale of products and publications when those items being sold do not have a substantial relationship to the exempt purpose of the organization (think café's, coffee houses, or bookstores).
- Renting your facilities to outside organizations for such things as; parking, cell towers, or to conduct personal business.
- Even some types of fundraising activities.

Generally, organizations that generate unrelated business income will be required to file IRS Form 990-T, Exempt Organization Business Income Tax Return, and pay tax on the income and no further reporting is required. However, if those activities become substantial in relation to your overall exempt purpose activities (here think more than 50% of total revenue), you may be putting your exempt status in jeopardy.

6. 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 Internal Revenue Code to ensure they continue to be recognized as tax-exempt. 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.

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. The type of form or notice required is generally determined by the public charity's gross receipts and the value of its assets. There are some public charities that are not required to file Forms 990 or 990-EZ, including churches and certain church-affiliated organizations.

Organizations that fail to file the required return for three consecutive years will automatically lose their tax exempt status with the IRS. 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.

Conclusion

Receiving an exemption from income tax and retaining that status is a significant benefit and responsibility that should not be taken lightly. Can you imagine the sort of questions the IRS might come back with if you ever had to reapply for exemption? Likely, second time around applications will be scrutinized far more closely than original applications given the IRS's concern that the organization might fall back on old habits. And given that the right to an exemption from income tax is considered a "privilege" under the tax code, one that comes with certain responsibilities, there is no law which requires the IRS to grant an exemption application the second time around if they are not convinced the organization will adhere to operating within its stated exempt purpose.

Consequently, maintain your exemption, once granted, should always be on the forefront of your mind when examining opportunities or evaluating inquiries from others who might want to have the organization operate in areas not really within its mission or purpose.

If you have questions about activities or situations you think might be putting your ministries exempt status in jeopardy talk to someone, your CPA, attorney, or a compliance professional who specializes in this area. And don't rely on the word or activities of another church or

ministry. Just because they are doing it or tell you they have never had any problems doesn't mean the activity is appropriate. They just haven't been questioned yet.

If we at CMA can be of any assistance to you on this important issue please feel free to contact us. We would be happy to be of assistance to you.

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