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How to Protect Your Tax-Exempt Status

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What would happen if your nonprofit lost its federal tax-exempt status? The thought might send shivers down your spine, and it should. Here are reminders about some of the actions that are required — or should be avoided — to maintain your 501(c)(3) status.

A titanic loss

If your 501(c)(3) designation is revoked, your nonprofit will no longer be exempt from federal income tax — it will have to pay corporate tax on annual profits. It also might be subject to back taxes and penalties for failure to pay corporate income taxes as of the revocation's effective date.

And that's just the tip of the iceberg. Losing your tax-exempt status also might subject your organization to state taxes on income, property, and sales or usage.

The hits on your finances wouldn't end there. Your donor base might be whittled away because donors would no longer be able to receive a tax deduction for their gift to your organization. And if you receive funding from private foundations, that would likely end, because their guidelines usually require grant recipients to be tax-exempt public charities.

But don't despair. If you play by the rules, your organization will likely be able to keep its special status.

Reporting duties

First of all, make sure that you're filing required reports on time. This involves filing some type of IRS Form 990 each year — Form 990, Form 990-EZ or Form 990-N, depending on the amount of your total annual receipts and total assets. If you fail to do so for three years in a row, your tax-exempt status will be revoked.

If you're required to file the full Form 990 or Form 990-EZ, be sure to annually complete Schedule A, Part I ("Reason for Public Charity Status") to identify why you aren't a private foundation. Check the box that coincides with the reason that you're a public charity for the current tax year.

Also on Schedule A, if your nonprofit is largely supported by a government unit or the general public or is a community trust (Box 5, 7 or 8 on Schedule A, Part I), you'll need to pass the public support test on Part II. If your organization is exempt because it receives more than onethird of its support from contributions and activities related to its exempt function, as outlined in IRC Section 509(a)(2), you'll need to pass the public support test on Part III each year.

You also must file all required payroll tax returns for your employees and 1099 forms for independent contractors, and answer related questions about these workers on your Form 990.

Executive compensation

Setting salaries for key employees requires a formal process. Information on the salaries and benefits you pay your executive director and "key" employees is available to the public on your Form 990. This has been identified as a primary focus of exempt organizations' audits by the IRS.

Even more important than the compensation total is the process you use to determine that the compensation is reasonable and comparable to amounts paid by organizations of similar size and activity. The IRS sees this review and approval as a responsibility of your board of directors or one of its committees.

Not only is granting executives an out-of-whack salary frowned upon, but you also can't operate for the "benefit of private interests." In other words, no part of a 501(c)(3) organization's earnings or equity can benefit individuals, such as the organization's founders, executives or board members — or their family members.

Unrelated business income

As your organization carries out its operations, it must be careful not to raise what's considered excessive unrelated business income (UBI). UBI is income from a trade or business activity that is regularly carried on that is unrelated to your exempt mission. Although the Internal Revenue Code is silent as to how much is too much, excessive UBI has been interpreted as spending a "significant" amount of time on the unrelated activity.

For example, if an organization has more expenditures for the unrelated activity than program expenses, the IRS likely will consider terminating its exempt status. But courts have considered a nonprofit spending even as little as 10% of its total efforts on a UBI activity to be too much.

Goods and services

Your organization also must make sure that it doesn't pay more than market rate for goods and services**.** It's wise to secure at least three quotes before purchasing a significant asset or establishing a service contract or standing order for supplies. If you ever decide to do business with related parties (board members, founders, executives or their businesses), the other quotes will support the "going rate" in your market and show you aren't providing an *excess* benefit to the related party.

Should the IRS determine that you've provided excess benefits, your organization and its leaders will be subject to penalties. The possibility of losing your exempt status also exists.

Lobbying and political campaign activities

The IRS requires that tax-exempt entities avoid "substantial" lobbying and political campaign activities. To determine whether lobbying activities are "substantial," consider the time spent by compensated employees and volunteers on lobbying activities or use an expenditure test.

Your nonprofit can elect to use the formal expenditure test — called a 501(h) election — by filing Form 5768. (Note that churches are ineligible.) The 501(h) election sets a defined limit on the amount of resources an organization can use to influence legislation before losing its exempt status, based on a percentage of its exempt purpose expenses.

Political campaign activities include making contributions to a political campaign fund or making public statements for or against a candidate (either written or verbal). Participating in any of these activities can result in the IRS either revoking your exempt status or imposing certain excise taxes on your organization.

Your lifeline

Your nonprofit's tax-exempt status is its lifeline. Make sure that you and your staff do all that is required to maintain it. Follow the suggestions above, and discuss the matter with your CPA.