



SMALL BUSINESS & NONPROFIT CLINIC

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**June 29, 2009**

## **5 Pitfalls: How small-to-mid-sized nonprofit corporations lose their tax-exempt status?**

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### Introduction

There are several obstacles that a nonprofit entity must overcome to achieve and maintain the 501(c)(3) status, or tax-exempt status. This memorandum identifies five common pitfalls that lead to the loss of tax-exempt status. First, the nonprofit entity must operate exclusively for the tax-exempt purpose in its Articles of Incorporation. At this stage, the IRS looks at the organizational documents to determine the tax-exempt status. Second, the nonprofit entity must satisfy the private inurement requirement. Essentially, the question is whether there is any private inurement or a substantial amount of private benefit. The answer must be in the negative to meet this requirement. Third, the nonprofit entity must meet the political activities requirement. Here, the question is whether there is substantial lobbying or any political campaigning. Once again, the question must be answered in the negative to meet this requirement. Fourth, the nonprofit entity must comply with unrelated business income requirements, particularly when gaming is involved. Lastly, the nonprofit entity must file all annual filings in a timely fashion.

### Operational

Of all the pitfalls, this pitfall is the easiest to satisfy. The IRS looks at the organizational documents to determine the tax-exempt status. Thus, as long as the entity carefully drafts the founding document, this requirement is met. For nonprofit corporations, the Articles of Incorporation is the founding document.

Furthermore, the IRS requires that a tax-exempt organization must operate exclusively for the tax-exempt purpose. Tax-exempt purposes include: charitable, religious, educational, scientific, literary, testing for public safety, fostering national or international amateur sports competition, and preventing cruelty to children or animals. Charitable purposes may be defined as:

- Relief of the poor, the distressed, or the underprivileged
- Advancement of religion, education, or science
- Erecting or maintaining public buildings, monuments, or works

- Lessening the burdens of government, or neighborhood tensions
- Eliminating prejudice and discrimination
- Defending human and civil rights secured by law; and
- Combating community deterioration and juvenile delinquency

In sum, the nonprofit entity should operate exclusively for the tax-exempt purpose in its Articles of Incorporation.

#### Private Inurement and Private Benefit

There are two rules under this pitfall. First, there must be no private inurement. Private inurement occurs when insiders, such as directors, to the organization derive a benefit from the organization's activities. Any amount of private inurement is too much. Here are some examples of private inurement:

- John is on the board of directors of "Helping Kids Exercise, Inc." and also owns a playground construction company. If Helping Kids Exercise hires John's construction company to build all of its playgrounds, this action would inure to the benefit of John. However, if the construction company charged a reasonable amount that is comparable to the amount any other company would have charged, then there is no inurement.
- John, director of Helping Kids Exercise, Inc., is paid \$1,000,000 per year for working 5 hours per week for the nonprofit. This compensation would inure to the benefit of John because the compensation is unreasonable.
- A nonprofit organization providing cancer screening services to the elderly refers all patients needing follow-up treatment to a for-profit medical clinic owned by the founder of the nonprofit. The referral would inure to the benefit of the founder.

Directors are normally not paid. However, directors, as well as employees, may receive reasonable compensation. Reasonableness is determined by comparing the compensation with the compensation received by people in similar positions with similar responsibilities. A properly-drafted conflict of interest policy helps reduce the risk of private inurement. The IRS provides an example of a conflict of interest policy in the Instructions for Form 1023. The example helps explain when a private inurement potentially exists. Furthermore, it will offer some helpful tools to avoid private inurement, such as the use of periodic reviews and outside experts.

Second, there should be no substantial private benefit. Unlike private inurement, private benefit may exist, but it must not be substantial. Private benefit occurs when the organization benefits a limited class of individuals. For example, if Helping Kids Exercise, Inc. provides playground equipment for the benefit of children living in a particular community development, then the children living in that particular community are a limited class of individual, and they would benefit from the playground equipment.

In sum, the nonprofit entity should operate without any private inurement for any insiders of the entity and without any substantial private benefit for non-insiders.

## Political Activities

The federal government does not want to favor certain legislation or political candidates. So generally, the IRS does not give tax-exempt status to nonprofit entities who engage in political activities. Political activities can be divided into two categories: Lobbying and Political Campaigning.

Lobbying is an attempt to influence the outcome of legislation. There are two types of lobbying: Direct and grass roots lobbying. Here are some examples and explanations of both types of lobbying:

- Direct Lobbying (“Dear Congressman, please vote no on HR 2000”):
  - Direct communication with any member or employee of a legislative body or government official who may participate in the formulation of legislation (“Dear Congressman”);
  - Communication refers to a specific legislation (“HR 2000”); and
  - Communication reflects a view on such legislation (“vote no”).
- Grass Roots Lobbying (“Please contact your Congressman and tell him to oppose HR 2000”):
  - Communication refers to specific legislation (“HR 2000”);
  - Communication reflects a view on such legislation (“oppose HR 2000”); and
  - Communication encourages the recipient of the communication to take action with respect to such legislation (“Please contact your Congressman”)

A nonprofit entity may lobby, however, substantial lobbying is not allowed. Substantial may be defined under two tests. The first test is known as the substantial part test. Under the substantial part test, the IRS considers a variety of factors such as the time devoted by employees and volunteers, and the expenditures devoted by the organization to determine whether the activity is substantial. Under the substantial part test, an organization that conducts excessive lobbying activity in any taxable year may lose its tax-exempt status.

The nonprofit may elect the second test under section 501(h), which is known as the expenditure test. Under Section 501(h), or the expenditure test, substantial may be found if more than 15% of the organization’s money is used in an effort to influence the outcome of legislation. Under this test, an organization that engages in excessive lobbying activity over a four-year period may lose its tax-exempt status.

Unlike lobbying, no amount of political campaigning is allowed. Political campaigning is defined as Statements or writings made on behalf of, or in opposition to, a political candidate. A candidate is any contestant of an elective office. One common mistake in this pitfall occurs when employees send political jokes through company e-mail or over a telephone conversation from the entity’s phone line. In sum, the nonprofit entity should operate without any political campaigning and without any substantial lobbying.

## Unrelated Business Income

Unrelated business income is income derived from a trade or business that is regularly carried on and is not substantially related to an organization's exempt purpose. Some common examples of unrelated business income are advertising, gaming, sale of merchandise and publications, and management or other similar services. However, some exceptions exist, such as:

- Activities conducted by volunteers
- Convenience
- Sale of donated merchandise
- Distribution of low cost articles
- Convention or trade show
- Sponsorship
- Bingo

If unrelated business activities become too large a part of its overall activities, then the entity may jeopardize its tax-exempt status. Unrelated business activities become too large a part of the entity's overall activities when the unrelated business activities become the primary purpose of the entity, rather than the tax-exempt purpose. To protect its tax-exempt status, a nonprofit entity should allocate less time and effort toward unrelated business activities and should focus on the exempt purpose.

If a nonprofit organization has \$1000 or more in gross receipts from unrelated business income, then they must file Form 990-T. Furthermore, if the nonprofit organization expects its taxes from unrelated business income to be greater than \$500, then it must file Form 990-W.

## Annual Filing

There are several forms of annual report filings. Small nonprofits (gross receipts are greater than \$25,000) must file Form 990-N: e-Postcard. Medium nonprofits (gross receipts are greater than \$25,000, but less than \$100,000, and total assets are under \$250,000) must file Form 990-EZ. Large nonprofits (gross receipts are greater than \$25,000) must file Form 990. Private foundations must file Form 990-PF. The filings are due the 15<sup>th</sup> day of 5<sup>th</sup> month after accounting period ends.

There are penalties for failure to file, or incomplete filing or incorrect filings. Typically, it is \$20 per day, but the penalty is capped at the lesser of \$10,000 or 5% of gross receipts. If the entity makes more than \$1 million in gross receipts, the penalties are as high as \$100 per day and capped at \$50,000. If the entity fails to meet annual filing requirements for 3 consecutive years, IRS will revoke exempt status.

Furthermore, the nonprofit entity should also file its annual report with the Department of Labor and Economic Growth, Corporate Division. Otherwise, the nonprofit entity will lose its good standing status. These annual reports are due October 1 and cost \$20 to file.

## Conclusion

In sum, a tax-exempt entity should be aware of these common pitfalls to avoid losing its tax-exempt status. First, the nonprofit entity should operate exclusively for the tax-exempt purpose in its Articles of Incorporation. Second, the nonprofit entity should operate without any private inurement for any insiders of the entity and without any substantial private benefit for non-insiders. Third, the nonprofit entity should operate without any political campaigning and without any substantial lobbying. Fourth, the nonprofit entity should not allocate more time and effort toward unrelated business activities and should maintain its focus on the exempt purpose. Lastly, the nonprofit entity should annually file the appropriate Form 990 to avoid penalties and tax-exempt revocation.