6 Ways Your Nonprofit Could Lose Its Tax Exemption

By Joanne Fritz

Tax Exemption Is a Privilege. Do not Jeopardize It.

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Congratulations if you have jumped through all of the hoops to become a 501(c)(3) organization. But now you must be careful that your actions don't draw attention from the IRS or cause you to lose your exempt designation.

1. Private Benefit/Inurement

Private Benefit. One important way a nonprofit differs from a for-profit organization is that it does not benefit any individual person or organization.

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.

Inurement goes even further by prohibiting a nonprofit's income or assets going to insiders such as officers, directors, or important employees. The property, for instance, cannot be sold to an insider below market value. 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.

It's harder than you might think to avoid these conflicts of interest, so it pays to understand some of the scenarios that might come up. Read How Board Members Can Avoid Conflicts of Interest for a mini-education about what to watch out for.

2. Lobbying

An organization lobbies when it tries to influence legislation. Some lobbying is permitted under certain circumstances. But this is tricky so it may be better not to lobby at all nor encourage anyone involved with your nonprofit to support, propose, or oppose any legislation.

If you engage in too much lobbying, the organization could be stripped of its exempt status and face a fine.

For more details on how the IRS handles the issue of lobbying on the part of 501(c)(3) organizations, see its tutorial on the subject.

3. Political campaign activity

501(c)(3) organizations cannot endorse or oppose any candidate for public office at the local, state or federal levels. This includes contributions to a political campaign and even public statements for or against a candidate. This prohibition is "absolute," meaning that any violation can cause the IRS to strip the 501(c)(3) of its tax-exempt status.

A 501(c)(3) may invite a political candidate to speak at an event IF no fundraising occurs, IF an equal opportunity to speak is extended to other candidates seeking the same office, and IF the organization does not indicate support for or opposition to any candidate.

If you think you see a 501(c) (3) nonprofit engaging in advocacy for an issue or candidate, it is likely to be a 501(c)(4) nonprofit, which has a different set of operating rules. Read about the differences between 501c3 and 501c4 nonprofits as they apply to political activity.

4. Too Much Unrelated Business Income (UBI)

The area of UBI is complicated, but basically, it means that your organization may not receive income from a **regularly-carried-on trade** or business that is **not related to your mission**.

If you generate funds from a business activity, but it is not regular, you may have to pay taxes on that income, but it won't jeopardize your tax-exempt status. An example would be selling merchandise once a year at a fair.

If your organization earns more than $1000 of UBI, you must file IRS Form 990-T (Exempt Organization Business Income Tax Return). Too much UBI can threaten your tax-exempt status. You could be in trouble if UBI takes up more time and attention than your mission. The IRS provides an excellent online tutorial on UBI that goes into the intricacies of this kind of income.

5. Not Filing an Annual 990 Tax Information Form.

All nonprofits must file a 990 annually. The kind of 990 you file depends on your size.

Although in the past small organizations were not required to file a 990, the Pension Protection Act of 2006 changed that.

Today, even small nonprofits must file the 990-N if they have gross receipts under

$50,000. If income fluctuates year to year, look at the average of receipts over the last three years. If that average is $50,000 or less, file the 990N. Fortunately, the 990-N is easy to file right online.

Larger 501(c)(3) nonprofits must file one of these types of 990. Unfortunately, many nonprofits lose their tax exemption every year because they failed to file a 990.

6. Failure to Pursue The Exempt Activities You Promised When You Applied to Be a Tax-Exempt 501(c)(3) Nonprofit.

When you applied for tax exemption, you stated that your purpose was one of these: "**Charitable, religious, educational, scientific, literary, testing for public safety, foster amateur sports competition, prevents cruelty to children or animals.**"

Furthermore, you wrote a mission statement that spelled out how you would accomplish your purpose.

You made a promise to serve the greater good. That earned your nonprofit its tax-exempt status. Don't break that contract or you risk losing your tax exemption. If your mission/purpose changes, you must notify the IRS.

It was hard work to get your nonprofit started, claim your tax exemption, establish revenue streams, and serve your community. Don't jeopardize your good work by ignoring the fine print of your contract with the IRS and the public.