



Tax-Exempt Status: How It Can Be Lost and How to Fight for It

What Is Tax-Exempt Status and Why It Matters

Tax-exempt status under Section 501(c) of the Internal Revenue Code allows qualified nonprofit organizations to operate free from federal income tax. This includes a wide range of organizations, such as charities, social welfare groups, trade associations, and more. For 501(c)(3) organizations, tax exemption allows an organization to more easily receive grants and to solicit tax-deductible donations. Federal tax exemption may qualify the organization for other benefits such as exemption from state and local filing fees, property taxes, or nonprofit mailing rates. Losing this status is likely to significantly disrupt operations and funding. Maintaining tax-exempt status is essential to fulfilling your mission, securing funding, and building public trust.

In the wake of a new administration and the deterioration of the rule of law, many organizations are worried about losing their tax-exempt status unjustifiably. We hope this resource demystifies what losing tax-exempt status actually looks like, makes clear that it is not something that can be taken away easily, and highlights the basic actions you can take to protect it.

I. What DOES NOT Happen When You Lose Tax-Exempt Status. Let us start with what does NOT happen when you lose tax-exempt status:

- Your assets are NOT frozen – you can continue to receive and spend money.
- Your nonprofit does NOT disappear – your board, officers, and can continue to operate the organization like they did before. And they could choose, in compliance with state law, to move the activities to a new organization or fiscal sponsor.
- You do NOT stop being a “nonprofit” – you stop being a “501(c)(3)” or “tax-exempt” but you are still a nonprofit organized for the same purposes, with the same mission and requirement to follow that mission.
- All of your *donations* do NOT become taxable – gifts are generally excluded from taxable income and donations are usually gifts.

II. What DOES Happen When You Lose Tax-Exempt Status

Net Income is Taxable: The organization will be treated as a taxable entity and subject to corporate income tax on any *net* operating or investment income (but not gifts) – you can still deduct expenses for your activities, but you are going to start paying tax on profits..

Back Taxes: Depending on the effective date of revocation, the organization could owe back taxes, interest, and penalties on *net* operating or investment income (but not gifts) earned since the date of revocation.

Deductibility of Donations: Contributions made *after* the revocation are not tax-deductible, but donors who did not have knowledge of the reasons you lost your tax-exempt status will typically NOT lose their deduction for gifts *already made*.

Impact on Grantmakers: The organization *may* no longer qualify for foundation grants, government contracts, or other funding streams limited to tax-exempt entities, but there are exceptions; for example, foundations and donor-advised funds could still make grants to non-exempt nonprofits using *expenditure responsibility*.

Reputational Harm: Revocation may lead to loss of public trust and support from donors, partners, and beneficiaries.

Loss of Other Benefits: Loss of state or local tax exemptions, eligibility for nonprofit postal rates, and exemption from certain employment taxes may also occur.

Administrative Overhead: Revocation requires updating public information, marketing material, communications to stakeholders, and/or an application for reinstatement, which can be time consuming and costly.

III. Why Tax-Exempt Status Is Most Commonly Lost

In spite of the current rhetoric, tax-exempt organizations rarely, if ever, lose their tax-exempt status because of where they stand on the issues. Recent threats made to unilaterally revoke nonprofits tax-exempt status are unlawful and unfounded. If you're afraid of losing your tax-exempt status, this is how it can happen:

1. Failure to File Informational Returns (Form 990) for Three Consecutive Years

Despite the term "tax-exempt," organizations with exempt status must still file informational returns with the IRS to document their exempt financial activities. Additionally, these organizations are only exempt from taxes on exempt activities; sometimes tax-exempt organizations undertake incidental, non-exempt activities that result in taxable income.

- **Failure to file** is the most common cause of revocation. IRS revocation is automatic after three years of missed filings.
- **What triggers it:** If a tax-exempt organization fails to file a required return (Form 990, 990-EZ, or 990-N) for three consecutive years, the IRS will automatically revoke its exempt status.
- **Why this matters:** This is the most common way organizations lose tax-exempt status and it's an automated, non-discretionary process.
- **When it's applicable:** The revocation date is set retroactively to the original due date of the third missed return.

- **Reinstatement:** The organization must apply for reinstatement using Form 1023 (or 1024) and may be able to request retroactive reinstatement with a reasonable cause explanation.

2. Revocation Following an IRS Audit or Investigation

The IRS may also revoke an organization's tax-exempt status as a result of an audit (also called an "examination") if it determines the organization is not operating in accordance with the requirements for exemption.

IV. What Triggers an Audit: An audit may be initiated due to red flags on Form 990, public complaints, referrals from other agencies, or random selection. In the case of red flags, these may include (but are not limited to):

- Inconsistencies in reporting such as numbers that don't add up.
- Large, unexplained changes in revenue or expenses.
- Unusually high percentages of unrelated business income, especially over multiple years.
- Excessive compensation or insider transactions.
- Missing or incomplete disclosures.
- High levels of foreign grants or offshore activity in high-risk jurisdictions.

Under Internal Revenue Code Section 7817, it is a criminal violation for the President, Vice President, or their employees to recommend to the IRS that a nonprofit be audited for loss of tax-exempt status. And right-wing activists and politicians may send you scary public letters, but they do not have the power to unilaterally start an audit either...

V. What Will You Need to Provide in Response to an Audit? The IRS will issue a notice of examination which typically comes with requests for extensive documentation and interview requirements. Every audit is different, but here are some common items that the IRS will request when it initiates an audit (so make sure you have them):

- Articles of Incorporation (and any amendments)
- Bylaws
- Minutes of all Board meetings and Board committee meetings.
- Organizational records, such as policy manuals, officer manuals, employee handbooks, etc.
- Copies of the organization's publications, newsletters, brochures, pamphlets, and other literature utilized and/or distributed in conducting the organization's activities.

- A copy of the organization's QuickBooks files and/or complete financial statements for all years under examination, including Chart of Accounts, General Ledger, Balance Sheet, Profit & Loss, Trial Balance
- Bank statements and similar financial records from other providers (e.g. Paypal, Square)

VI. What the IRS looks for during an audit:

- **Private benefit or inurement** – for example, founders or board members receiving improper financial benefits.
- **Prohibited political activity** – for example, a 501(c)(3) providing partisan support to a political candidate or party, or conducting legislative lobbying in excess of applicable limits
- **Operational test failure** – the organization is not primarily engaged in activities that further exempt purposes.
- **Diversion of assets** – use of funds for personal, unrelated, or improper purposes.
- **Lack of adequate records or governance** – failure to demonstrate proper oversight or compliance.

VII. What Happens Next: The organization will provide the IRS with the requested documents and have an interview with the examiner, typically on the organization's premises (the examiner may request a facilities tour). The IRS may issue multiple information and document requests (IDRs) requesting additional information or asking follow-up questions. This process can take a number of months. Once that process is complete, the IRS will issue a written report with proposed findings.

In most audits, the outcome is NOT revocation – instead, the IRS may decide there are no issues. Or they may assess certain penalties or require the organization to agree to make changes moving forward, but leave the tax-exempt status. In the relatively uncommon scenario where revocation is recommended, the organization will receive a proposed revocation letter (commonly called a “30-day letter”) to its address on file. The organization has the opportunity to respond or appeal through a conference with the IRS Office of Appeals. If the Office of Appeals does not overrule the examiner, the IRS will issue a final revocation letter. The revocation may be retroactive to the start of the tax year under audit, unless reinstated. Reinstatement is possible but typically requires a new exemption application and corrective action.

VIII. Why Understanding the Process Matters: Unlike automatic revocation, this is a fact-based, discretionary process that may involve significant legal and financial exposure, as well as time from leadership away from charitable activities, to support the documentation requirements and interview process. BUT it is also time and cost intensive from the government's

perspective – it takes a lot of work for the IRS to revoke an organization’s tax-exempt status, and you have many opportunities to fight for right to maintain exemption if you are operating properly.

IX. What You Can Do to Protect Your Tax-Exempt Status: Staying compliant with IRS rules doesn’t have to be overwhelming. Here are a few practical steps to help protect your organization’s tax-exempt status:

- **File your annual returns (Form 990 series) on time**—even if your revenue is low or the organization is inactive. You may also file an extension.
- **Keep clear records** of your finances, programs, and governance decisions. Adopt and follow a document retention policy, and don’t keep records for longer than mandated by your policy.
- **Make sure your activities match are consistent with your tax-exempt purposes** and check in regularly to confirm. There are many activities that fit within 501(c)(3), but there are limits. If you are not asking the question about whether your work is sufficiently charitable or educational to qualify, you may taking on some risk.
- **Avoid *excessive* private benefit and *prohibited* political activity** that could jeopardize your exemption. But do not forget that there are many permissible types of advocacy that you can do without any legitimate threat to your exempt status.
- **Consult with experienced advisors** when undertaking new program areas, or if you’re unsure about compliance.
- **Ensure your contact information is up to date** with state and federal agencies, so that you can respond to any notices you receive in a timely manner.

If your organization has already lost its tax-exempt status, don't panic! Many groups successfully regain their exemption. The key is to act promptly, correct what went wrong, and take steps to avoid future issues.

And if someone is merely *threatening* to take away your tax-exempt status, you *definitely* do not need to panic. An organization operating for charitable or educational purposes is entitled to tax-exempt status regardless of whether its viewpoint is popular.

Being resilient to unlawful threats against your tax-exempt status does not mean you should be compromising your mission or choosing your words more carefully – you just need to be ready to fight for it.