Understanding Tax Exemption for the Rescue Mission

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The Church and Nonprofit Organization Tax & Financial Reporting Guide

Chapter Two - “Tax Exemption”

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Introduction

Most churches are tax-exempt entities that do not have to pay federal income taxes and do not have to apply for tax status. This is not the case with most rescue missions, which must apply for, and maintain, federal tax-exempt status. Exemption from federal income tax does not automatically provide exemption from state taxes such as property, sales, and use tax. Churches and other nonprofit organizations may be subject to the unrelated business income tax. Tax-exempt funds must be diverted for personal use. This is called private inurement or benefit.

The term “nonprofit organization” is used for all sorts of entities; churches, colleges, universities, hospitals, clubs, political parties, etc. Where they get their money, who owns the organization, and what types of activities it conducts determine whether the organizations is a “for-profit” or “nonprofit” organization. Rescue mission fit into the most common type of nonprofits, the charitable organization. “Eleemosynary” is another legal term that is occasionally used to refer to an nonprofit tax-exempt organization.

Nonprofit organizations are chartered by state law. Tax exemption is granted by the federal government under Section 501(c)(3) of the Internal Revenue Code. In federal law, the IRS does not use the term “nonprofit,” but instead refers to such entities as “exempt organizations.”

Being chartered as a “not-for-profit” by a state does not automatically qualify an organization for tax-exempt status under federal law. These are two separate processes.

The most important benefit of tax exempt status is the fact that donations to the organization are tax deductible for individual and corporate donors. Nonprofit status also brings with it exemption from income, sales, and property taxes.

Advantages and Limitations of Tax Exemption

The IRS grants tax exempt status to organizations that meet the requirements of the tax code. While this status means the organization does not have to pay federal income taxes, it still may not be exempt from local and state income taxes. This must be handled on a state-by-state basis. Additionally, there are a few federal taxes for which a tax exempt organization may still be responsible. These relate mainly to what is known as “unrelated business income” and taxes imposed upon political and legislative activities.

Advantages

- Exemption from federal income and excise tax
- Donors can deduct their contributions on personal tax returns. IRS Publication 78 is the Cumulative List of Organizations to which tax deductible contributions may be
made.

- Lower postal rates on third-class bulk mailings
- Can seek funding from foundations and other philanthropic entities that normally support only organizations that have 501(c)(3) tax exempt status.
- Can receive government grants available only to entities exempt under 501(c)(3).
- Exemption from state and local income taxes
- Property used directly for its exempt activities is usually free from property taxes
- Exemption from certain sales and use taxes
- In most cases, rescue missions qualify for exemption from the Federal Unemployment Tax Act.
- Its employees may participate in 403(b) annuities, a special type of retirement plan that is only for those who work at nonprofit organizations.
- Free radio and television public service announcements (PSAs)
- If the organization is opposed on religious grounds to the payment of FICA social security taxes, it may elect not to withhold these from employee salaries. However, the employees of such organizations become responsible to pay their own social security taxes as self-employed individuals.

Limitations of Tax Exempt Status

- The organization must engage in qualified charitable or educational activities.
- It is limited as to how much it may engage in substantial legislative and political activities.
- The organization cannot be involved in unrelated business activities and is limited as to the extent of profit-making commercial activities in which it can participate.
- There is a prohibition against private inurement or private benefit.
- If the organization is disbanded (dissolution), it assets must be handed over to another tax exempt organization or distributed for one or more exempt purposes.
Safeguarding an Organization’s Tax Exempt Status

Any of the following can place an organization’s tax exempt status in jeopardy:

A. Private Benefit and Private Inurement

B. Unrelated Business Income (UBI)

C. Engaging in Prohibited Political Activity

D. Failures in Reporting

A. Private Benefit and Private Inurement

According to law, a nonprofit organization exist to serve public, and not private, interests. The law does allow some private benefit if it is incidental to the public benefits involved. It is acceptable if the benefit to the public cannot be achieved without necessarily benefiting private individuals.

Example: The IRS revoked exemption of a charity where it served the commercial purposes and private interests of a professional fund-raiser where the fund-raiser distributed only 3% of the amount collected to the nonprofit organization.

Private inurement is a subset of private benefit. This is an absolute prohibition that generally applies to an organization’s “insiders.” These include its founders, trustees or directors, officers, managers, or significant donors. While financial transactions that involved these individuals are not necessarily illegal, they must be reasonable and be documented, and reported to the IRS.

Basically, inurement happens when an individual is benefited by a transfer of financial or other resources solely because of his or her relationship with the organization and is not accomplished within the boundaries of its exempt purposes. When an individual receives something for nothing or less than it is worth, private inurement may have occurred. Excessively high compensation can also result in prohibited inurement.

The following questions can determine if a situation represents inurement:

- Did the expenditure further an exempt purpose, and, if so, how?
- Was the payment at fair market value or did it represent reasonable compensation for goods and services?
- Does a low- or no-interest loan to an employee or director fall within a reasonable compensation package?
On an overseas trip for the nonprofit, did the employee (and perhaps a spouse) stay an additional week for a personal vacation and charge the expenses to the organization?

Example 1: An organization lost its exemption where it engaged in numerous transactions with an insider, including the purchase of a 42-foot boat for the personal use of the insider. The insider also benefited from several real estate transactions, including donations and sales of real property to the organization which were never reflected on its books.

Example 2: A church lost its tax-exemption after it operated commercial businesses and paid substantial private expenses of its founders, including expenses for jewelry and clothing in excess of $30,000 per year. The church also purchased five luxury cars for the founders’ personal use. None of these benefits were reported as personal income to the founders.

Example 3: A tax-exempt organization transfers an auto to an employee for $100. The transfer was not approved by the board and does not constitute a portion of a reasonable pay package. The fair market value of the auto is $2,000. The net difference of $1,900 is not reported to the IRS as compensation. Private inurement has occurred.

Example 4: Same facts as Example 3, except the transfer was approved by the board and properly constituted a portion of the reasonable pay package, and the $1,900 was added to the employee’s Form W-2 as compensation. There is no private inurement.

B. Unrelated Business Income (UBI)

Most nonprofit organizations have a number of different sources of operating funds; contributions of money and goods (in-kind donations), grants, collection of fees for exempt services performed, and sales of items that are related to its exempt purposes. All income from these sources is exempt from federal income tax unless the income is generated by an activity that is:

- Is not substantially related to the organization’s exempt purpose or function,
- a trade or business, and
- regularly carried on.

A trade or business means any activity regularly carried on which produces income from the sale of goods and services and where there is a reasonable expectation of a profit. To decide whether a trade or business is regularly carried on, the IRS considers whether taxable organizations would carry on a business with the same frequency and continuity. Intermittent activities may escape the “regularly carried on” definition.
According to the IRS regulations, a trade or business must “contribute importantly to the accomplishment of the exempt purposes of an organization” if it is to be considered “substantially related.” Even if all the profits from a business go to support the work of the nonprofit, the profits may still be taxed.

The definition of “unrelated trade or business” does not include activities:

- In which unpaid volunteers do most of the work for an organization;
- That are provided primarily for the convenience of the organization’s members;
- That involve the sale of merchandise mostly donated to the organization.

**Activities That Are Not Taxed**

Income from the following sources is generally not considered as UBI:

- **Passive income.** Income earned from most passive investment activities is not UBI unless the underlying property is subject to debt. Types of passive income include: dividends, interest, and annuities, capital gains or losses from the sale, exchange, or other disposition of property, rents from real property (some rents is UBI if the rental property was purchased or improved subject to a mortgage), royalties (oil and gas working interest income generally constitute UBI).

- **Volunteers.** Any business where volunteers perform most of the work without compensation does not qualify as UBI. To the IRS, “substantially” means at least 85% of total work performed. Example: A used-clothing store operated by a nonprofit orphanage where volunteers do all the work in the store would likely be exempt.

- **Convenience.** A cafeteria, bookstore, or residence operated for the convenience of patients, visitors, employees, or students is not a business. Stores, parking lots, and other facilities may be dually used (part related and part unrelated).

- **Donated goods.** The sale of merchandise, mostly received as gifts or contributions, does not qualify as UBI. A justification for this exemption is that contributions of property are merely being converted into cash.

- **Low-cost items.** Items (costing no more than 56.60—1995 adjusted amount) distributed incidental to the solicitation of charitable contributions are not subject to UBI. The amounts received are not considered as an exchange for the low-cost articles and therefore they do not create UBI.

- **Mailing lists.** Mailing lists exchanged with or rented to another exempt organization are excluded from UBI, although the commercial sale of the lists will generally create UBI. The structuring of the agreement as a royalty arrangement may make the income exempt from UBI treatment.
Avoid problems with UBI by:

- Maintaining careful records of income and related expenses (both direct and indirect, including depreciation) for any activities that might be considered unrelated to the exempt purpose of your organization. These records should include allocations of salaries and fringe benefits based on time records or, at a minimum, time estimates.

- Keeping a separate set of records on potential unrelated activities. This separate set of records would need to be submitted to the IRS only upon audit.

- Insuring that board minutes, contracts, and other documents reflect the organization's view of relatedness of various activities to the exempt purpose of the entity.

- Filing Form 990 T if the organization has over $1,000 of gross UBI in a given fiscal (tax) year.

C. How to Avoid Engaging in Prohibited Political Activity

Churches and other organizations exempt from federal income tax under section 501(c)(3) of the Internal Revenue Code are prohibited from participating or intervening, directly or indirectly, in any political campaign on behalf of or in opposition to any candidate for public office.

To avoid violating the political campaign provisions of the law:

- Do not use a rating program to evaluate candidates.

- Do not endorse a candidate directly or indirectly through a sermon, speech, newsletter, or sample ballot.

- Do not publish a candidate’s statement.

- Do not publish the names of candidates who agree to adhere to certain practices.

- Do not publish candidate responses to a questionnaire that evidences a bias on certain issues.

- Do not publish responses to an unbiased questionnaire focused on a narrow range of issues.

- Do not raise funds for a candidate.

- Do not provide volunteers, mailing lists, publicity, or free use of facilities unless all parties and candidates in the community receive the same services.
• Do not pay campaign expenses for a candidate.
• Do not distribute statements about candidates or display campaign literature on organization’s premises.

If the IRS finds that an organization has engaged in these activities, it could result in a loss of exempt status. Also, the IRS may assess an excise tax on the amount of the funds spent on the activity.

Are there any political campaign activities that may legally be engaged in by a church or nonprofit? Forums or debates may be conducted to educate voters at which all candidates are treated equally, or a mailing list may be rented to candidates on the same basis as it is made available to others. Organizations may engage in voter registration or get-out-the-vote activities. However, it is wise to avoid defining a target group by political or ideological criteria (e.g., encouraging individuals to vote who are “registered Republicans”).

C. Filing Federal Returns

Nearly all nonprofit organizations must file an annual return with the IRS (churches are exempt from filing Form 990 or 990-EZ). The basic filing requirements are

<table>
<thead>
<tr>
<th>FORM TO BE FILED</th>
<th>CONDITIONS</th>
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<tbody>
<tr>
<td>No form filed</td>
<td>Gross annual receipts normally under $25,000</td>
</tr>
<tr>
<td>Form 990-EZ</td>
<td>Gross annual receipts between $25,000 and $100,000 with total assets of less than $250,000</td>
</tr>
<tr>
<td>Form 990</td>
<td>Gross annual receipts over $100,000 or assets over $250,000 with gross annual receipts between $25,000 and $100,000</td>
</tr>
<tr>
<td>Form 990-T</td>
<td>Any organization exempt under Sec. 501(a) with $1,000 or more gross income from an unrelated trade or business</td>
</tr>
<tr>
<td>Form 1120</td>
<td>Any nonprofit corporation that is not tax-exempt</td>
</tr>
<tr>
<td>Form 5500</td>
<td>Pension, profit-sharing, medical benefit, cafeteria, and certain other plans must file annually one of several series 5500 Forms.</td>
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Public Inspection of Information Returns

Nonprofit organizations must make copies of Forms 990 and 990-EZ for the three most recent years available to the public at any of their offices (with three or more employees).
during regular business hours. Copies of the application for tax exemption (if applicable) also must be made available. There are penalties for failure to comply.

The following procedures may be followed to meet this requirement:

1. Make copies of the information returns for the last three years, excluding only the list of contributions required to answer: (1) Part I, question id, (2) Schedule A, Part IV, question 26b. The details of the officers’ annual salaries and expense reimbursements (in Part IV and in Schedule A, Part I) are available to the public. Also make a copy of the tax-exempt application and related correspondence or supporting documents.

2. When someone comes in and asks to see the documents, tell the guest that (1) the copies of the forms are ready and available for them to review, (2) a staff member will be happy to answer any questions about the documents, (3) the copies must be returned to the organization and may not be retained by the guest, and (4) that copies can be obtained by writing to the IRS on Form 4506-A.

3. Keep a log showing the names and addresses of the individuals who reviewed the documents.

Reporting Substantial Organizational Changes

An organization’s tax-exempt status remains in effect if there are no material changes in the organization’s character, purposes, or methods of operation. Significant changes should be reported by letter to the IRS soon after the changes occur.

Example: An organization received tax-exempt status for the operation of a religious radio ministry. Several years later, the organization decided to add a facility for homeless children. This change would likely be deemed to be material and should be reported to the IRS.

Change In Accounting Methods

A nonprofit organization may adopt any reasonable method of accounting to keep its financial records that clearly reflects income. These methods include the cash receipts and disbursements method; the accrual method; or any other method (including a combination of methods) that clearly reflects income.

An organization that wishes to change from one method of accounting to another must secure the consent of the IRS to make that change. Consent must be obtained both for a general change of method, and for any change of method with respect to one or more particular items. Thus, a nonprofit organization that generally uses the cash method, but uses the accrual method with respect to publications for which it maintains inventories may change its method of accounting by adopting the accrual method for all purposes. But the organization must secure the IRS consent to do so.
To obtain the consent of the IRS to change an accounting method, the organization should file IRS Form 3115, Application for Change in Accounting Method. The form must be filed within 180 days after the beginning of the tax year in which the change is made. There is a more expeditious consent for a change from the cash to accrual method filed under Revenue Procedure 85-37.

Change of Fiscal Years

Generally, an exempt organization may change its fiscal year simply by timely filing Form 990 with the appropriate Internal Revenue Service Center for the “short year.” The return for the short year should indicate at the top of page 1 that a change of accounting period is being made. It should be filed not later than the 15th day of the fifth month following the close of the short year.

If neither Form 990 nor Form 990-T must be filed, the ministry is not required to notify the IRS of a change in the fiscal year, with one exception. The exception applies to exempt organizations that have changed their fiscal years within the previous ten calendar years. For this exception, Form 1128 must be filed with the IRS.

Other

- Form 5578. Form 5578 may be completed and furnished to the IRS to provide information regarding nondiscrimination policies of private schools instead of completing the information at item 31 of Form 990, Schedule A. If Form 990 is not required to be filed, Form 5578 should be submitted, if applicable. Form 5578 must be filed for schools operated by a church, including pre-schools.

- Form 8717 and 8718. Nonprofits wishing IRS private letter rulings on exempt organization information or on employee plans must include new forms 8717 or 8718, respectively, with the appropriate fees.

- Form 8282. If a nonprofit donee sells or otherwise disposes of gift property for which an appraisal summary is required on Form 8283 within two years after receipt of the property, it generally must file an information return (Form 8282) with the IRS. See Chapter 7 for more information on these reporting rules.

- Employee and nonemployee payments. As an employer, a nonprofit organization must file federal and state forms concerning payment of compensation and the withholding of payroll taxes. Payments to nonemployees may require the filing of information returns. See Chapters 4 and 5 for more coverage on these requirements.

Filing state Returns

Separate filings are often necessary to obtain exemption from state income tax.
The requirements vary from state to state. In some states it is also possible to obtain exemption from sales, use, and property taxes.

A nonprofit organization may be required to report to one or more states in relation to its exemption from or compliance with state income, sales, use, or property taxation.

Many states accept a copy of Form 990 as adequate annual reporting for tax-exempt status purposes. Annual reporting to the state in which the organization is incorporated is normally required even if there is no requirement to file Form 990 with the IRS. Check with the offices of the secretary of state and attorney general to determine required filings.

Do not send a list of major contributors to the state unless it is specifically required. While this list is not open to public inspection with respect to the federal filing, it may not be confidential for state purposes.