

Notice: This guide is for informational purposes only and does not provide legal advice or create an attorney-client relationship. You should contact an attorney to obtain advice with respect to any particular issue or problem.

HOW TO AVOID LOSING NONPROFIT TAX-EXEMPT STATUS

An attractive feature of nonprofit organizations is tax exemption. However, the IRS may revoke an organization's tax-exempt status if it engages in restricted or prohibited activities or fails to comply with tax filing requirements. The nonprofit organization should implement appropriate governance and oversight procedures, which will make it easier to monitor the organization's compliance and maintain its tax-exempt status.

What activities can jeopardize a 501(c)(3) organization's tax-exempt status?

There are five main things that could jeopardize the nonprofit organization's tax-exempt status: failing to file the annual information return (Form 990), generating excessive unrelated business taxable income, lobbying, political campaigning, and conferring private benefits.

Failing to File the Form 990: 501(c)3 tax-exempt organizations must file an annual information return unless the organization qualifies for an exception. Failing to do so may result in revocation of the organization's tax-exempt status. If you do not file the organization's annual return three years in a row, the organization will automatically lose tax exemption status. For more information, check out the [NONPROFIT TAX REPORTING OBLIGATIONS: UNDERSTANDING FEDERAL AND MASSACHUSETTS FILINGS Q&A](#).

Unrelated Business Income: Unrelated Business Taxable Income, or UBI, is income of a general commercial nature that does not serve a public benefit. While income generated through the nonprofit organization's activities is generally exempt from federal or state corporate income tax, income classified as UBI is taxable at the federal corporate tax rate. If an organization generates excessive UBI, their tax-exempt status may be revoked. To better understand what counts as UBI, check out the IRS's [Unrelated Business Income](#) course.

Lobbying: Lobbying is any activity that seeks to influence lawmaking. 501(c)(3) organizations can only conduct an "insignificant" amount of lobbying without jeopardizing exemption. To identify whether the nonprofit organization's lobbying activities are significant, use the IRS's [Substantial Part Test](#) or safe harbor [Expenditure Test](#) to determine whether the organization's lobby activities are allowable. For smaller nonprofit organizations, the Expenditure Test likely provides a simpler test to determine the lobbying limitations.

Political Campaign Activity: Participating in a political campaign on behalf of or in opposition to a candidate for public office is prohibited. For example, the nonprofit organization should avoid endorsing, opposing, or making a financial contribution to a specific candidate, or offering access for only specific candidates to use the organization's facilities or to speak at events.

Serving a Private Interest: 501(c)(3) tax-exempt organizations cannot primarily operate to produce advantages, gains, or profits for key individuals like the founders, founders' family, shareholders, directors, officers, or other individuals with a private interest. The organization must ensure that any benefit to these individuals is minor compared to the public's benefit. For information on how to navigate situations where a key individual could receive a benefit, see "What are conflicts of interests and how an organization can avoid or management them?" below.

How should an organization structure its governance to maintain compliance with tax-exemption requirements?

Best practices include maintaining a clear and publicly expressed mission, an engaged, informed, and independent board, policies, and procedures to protect the organization's assets, and transparency in the board's decision-making through proper record keeping.

What does proper recordkeeping look like?

Maintaining accurate and complete records helps ensure that the organization can maintain and defend its tax-exemption status. While there is no one-size-fits-all approach to recordkeeping, the organization should enact policies requiring the recording of board minutes, document retention, accurate completion of its Form 990, and the ongoing monitoring of any potential political involvement. Additionally, the organization should permanently retain board minutes and governing documents. Nonprofit organizations should also ensure that they record their income, expenses, contributions, and any other financial transactions accurately and on a timely basis in accordance with applicable Generally Accepted Accounting Principles (GAAP) standards. Additionally, the organization should memorialize its procedures for maintaining records and update as needed.

What are conflicts of interest and how can an organization avoid or manage them?

A conflict of interest occurs when an individual within an organization has a personal interest that clashes with the interests of the organization. Nonprofit organizations can avoid conflicts of interest by establishing policies that maintain the transparency and independence of their decision-makers. Documenting board activity and disclosing any known or potential conflicts ensure board transparency. The best practice is to disallow board members from voting on or participating in board discussions relating to matters where their personal interests are in conflict. Best practices recommend maintaining an independent board, free of conflicts of interest, to ensure IRS compliance.

What should an organization do if it receives a notice of revocation for failure to file annual reports?

If the organization fails to file the required annual return for three consecutive years, then it could be subject to automatic revocation by the IRS. If the organization receives a notice of revocation

because it failed to file and the organization believes it to be incorrect, the organization may reapply for reinstatement. If the organization reapplies within 15 months of revocation, it can take advantage of a streamlined process to obtain reinstatement retroactive to the date of revocation. If the revocation was over 15 months prior, the organization's tax-exempt status may still be retroactively reinstated, but the organization must provide reasonable cause for failing to file a required annual return for all three consecutive years in which it failed to file. The organization should also record revenue collected during the organization's tax-exempt status revocation period and pay any applicable income tax for that period. The IRS may allow for retroactive reinstatement if the organization can establish a reasonable cause for its noncompliance.

Conclusion

Understanding how to maintain tax-exempt status is crucial for an organization to continue its exempt purpose work and avoid unexpected tax liabilities. Organizations can protect their exempt status by complying with IRS and state reporting obligations, avoiding conflicts of interest and political activities, and limiting revenue derived non-exempt business activities. With the above knowledge, nonprofit organizations can ensure long-term compliance and safeguard their tax-exempt benefits.

Looking for legal help? Contact the following legal organizations to see if you qualify for free legal assistance!

Legal Food Hub
legalfoodhub.org
legalfoodhub@clf.org

1-844-LAW-GROW (1-844-529-4769)

Northeastern University Community Business Clinic
<https://law.northeastern.edu/experience/clinics/community-business/>

617-373-6435

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