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## What to Do When a Nonprofit Client Loses Tax-Exempt Status

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There are close to 2 million tax-exempt organizations operating in the United States.

Until recently, once an organization received its determination from the IRS that it was exempt, it was permanent unless affirmatively revoked by the IRS. Although a significant number of these tax-exempt organizations were required to file an annual return, many failed to do so; a majority were not required to because they did not meet the filing threshold.

### Filing Requirements

Prior to 2007, most organizations whose gross receipts were less than \$25,000 were not required to file an annual return. Congress then passed the Pension Protection Act of 2006, requiring most tax-exempt organizations to file an annual information return or notice with the IRS.

For tax years beginning after 2006, the IRS introduced the new annual electronic filing requirement for small tax-exempt organizations, the Form 990-N Electronic Notice (e-Postcard) for Tax-Exempt Organizations Not Required to File Form 990 or 990-EZ. The new law states that an organization failing to file an annual return or notice as required for three consecutive years will automatically lose its tax-exempt status.

### The First Revocations

In June 2011, the IRS announced that 275,000 nonprofits lost their tax-exempt status because they failed to file the required annual documents for three consecutive years. The IRS publishes a list of organizations that have had their tax-exempt status automatically revoked, updating the list monthly.

Revocation of tax-exempt status can have significant financial and social affects. Once an organization's tax-exempt status is revoked and the revocation published, it is no longer eligible to receive tax-deductible contributions. The organization may still accept donations, but the donations would not be deductible.

Many organizations that provide grants will only do so upon proof of tax-exempt status. For private foundations and sponsors of donor-advised funds, payouts made to a charity that has received a revocation letter will no longer be qualified distributions, thus subjecting them to possible excise taxes. An organization that has had its exempt status revoked will be required to file a federal income tax return and pay federal income taxes, may incur penalties for failure to pay income taxes, and substantially risks losing donors and members.

### Reinstatement of Tax-Exempt Status

Most of the organizations affected by the initial round of revocations are believed to be defunct. However, groups that are still operating

may apply to get their exempt status reinstated by filing Form 1023 or Form 1024. Those who worked on filing the original Form 1023 or Form 1024 know that this may be a tedious and time-consuming task.

Organizations normally with annual revenues of \$50,000 or less may apply for transitional relief by applying for reinstatement of exempt status by Dec. 31, 2012. By doing so, they will be treated as having had reasonable cause for not filing, and their status will be retroactively reinstated to the date it was automatically revoked.

Organizations with annual revenues greater than \$50,000 can apply for retroactive reinstatement. The application must contain a statement of reasonable cause for failure to file, and a statement describing the safeguards put in place to ensure it doesn't happen again. There must also be evidence to substantiate these statements, along with annual information returns for all tax years during and after the consecutive three-year period that the organization was required, but failed, to file an annual return. The organization must also pay the applicable user fee.

The organization will also have to consider additional expenses should they require professional assistance with their reinstatement. Upon reinstatement, the IRS will issue a new determination letter to the organization. Unfortunately, the IRS will not expedite applications for reinstatement unless the organization can prove it has a compelling reason.

**Increased Transparency for Nonprofits**

As with the revamp of the Form 990 in 2008, the IRS is hoping that this new revocation process will increase transparency and lead to a more accurate picture of the nonprofit sector. Donors, grantors, members, clients and other stakeholders will have more confidence that the organizations receiving their support have reported as required and deserve their trust.

If you are a calendar-year organization and filed for a second extension, your final filing deadline for the 2010 tax year is Nov. 15, 2011.

The process of qualifying for tax-exempt status with the IRS can be a long and tedious process and is far more stringent and difficult than in past years. As of September 2011, the service was only working on applications received in March 2011, which is already a six-month lag. Don't risk letting your nonprofit clients lose their tax-exempt status by failing to file an annual return as the consequences are severe and costly.

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