

FLIRTING WITH DISASTER: A LOOK AT HOW TAX-EXEMPT STATUS CAN BE REVOKED

Posted on **October 18, 2017** by **Jim Malone**



When a non-profit loses its tax-exempt status under the Internal Revenue Code, it is frequently the end of the organization.

Sometimes the problem is easily resolved; an exempt organization that has its status revoked because it failed to file its annual returns on Form 990 can be reinstated retroactively if it acts promptly. See Rev. Proc. 2014-11, 2014-3 I.R.B. 411; see *also* Rev. Proc. 2017-5, 2017-1 I.R.B. 230. But in most other cases, the loss of the exemption is a disaster:

- First, the organization will be liable for income taxes that were not part of its budget.
- Second, its sources of funding will likely disappear, as donors will no longer receive a tax deduction, and governmental grants may be conditioned upon tax-exempt status.

A recent Tax Court case illustrates the adverse impact that revocation can have on an exempt organization: The IRS commenced an audit for an exempt organization's 2002 990 filing in 2003; the examination was completed in 2012, and the IRS ultimately issued a tax assessment of \$216,547, along with interest of \$142,185. The Tax Court held that the interest started to accrue as of the date when the exempt organization should have filed a corporate income tax return for the 2002 tax year, even though its exemption was revoked years later. *CreditGuard of Am., Inc. v. Comm'r*, No. 1332-16L, 2017 U.S. Tax Ct. LEXIS 52, *9-*13 (Oct. 10, 2017).

Given the adverse impact that revocation can have on an exempt organization, this post will cover the process that the IRS uses when it elects to revoke an exemption and the available responses of the organization.

Officers and directors of exempt organizations should first understand that the purpose of audits is to assure compliance, as the Internal Revenue Manual explains:

The purpose of selection and examination of returns is to promote the highest degree of voluntary compliance with the statutes governing qualification of plans and exemption of certain types of organizations from tax and to determine the extent of compliance and the causes of noncompliance with the tax laws by plans and organizations.

Policy Statement 4-119, I.R.M. ¶ 1.2.13.1.36 (08-03-1988).

Second, they should understand that the standards governing exempt status can be violated inadvertently. Section 501(c)(3) of the Code requires organizations to meet both an organizational and an operational test to qualify for an exemption. Treas. Reg. § 1.501(c)(3)-1(a)(1) (“In order to be exempt as an organization described in section 501(c)(3), an organization must be both organized and operated exclusively for one or more of the purposes specified in such section.”). While the organizational test is straight-forward, the operational test is not. Changes in an organization’s operations can cause problems if they suggest that more than an insubstantial portion of its activities do not further its charitable purpose. New programs can also cause problems if they create some private benefit to someone.

Third, officers and directors of exempt organizations should understand that the IRS has enormous discretion if it finds that there is a violation of the qualification standards. For example, hospital organizations are required to have a financial assistance policy for patients. I.R.C. § 501(r)(1)(B). Among other requirements, this policy must be publicized widely. I.R.C. § 501(r)(4)(A)(v). In theory, a hospital organization that does not take appropriate measures to publicize its financial assistance policy could lose its tax exemption. In reality, that is not a likely outcome if the organization is otherwise compliant; instead, it is likely to receive instructions on corrective actions that should be taken.

If the IRS does elect to pursue a revocation, then the question becomes when is the revocation effective. The IRS generally endeavors to make revocation effective as of the date “when the organization first failed to qualify for exempt status.” I.R.M. ¶ 4.75.13.8.3(1) (04-11-2017). The examiner is required to get managerial approval to expand an audit into prior years, and that generally will not be done if the assessment statute of limitations has expired. I.R.M. ¶ 4.75.13.8.3(5) (04-11-2017). If the failure to qualify occurred in a prior year and the audit is not expanded to prior years, then the effective date will be as of the beginning of the year under audit. I.R.M. ¶ 4.75.13.8.3(6) (04-11-2017).

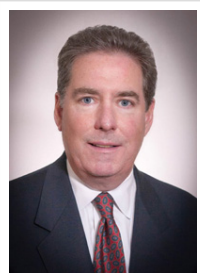
In egregious cases, however, the IRS can revoke the exemption retroactively to the date the organization was incorporated. See *Partners in Charity, Inc. v. Comm’r*, 141 T.C. 151 (2013). Partners in Charity, Inc. (“Partners” or “PIC”) was formed to assist low-income families through down payment assistance. *Id.* at 152. While it had represented to the IRS that it would solicit individual donations to fund its program, in the vast bulk of its transactions, Partners obtained the funds from sellers, along with a fee. *Id.* at 153-54. There were also issues whether it actually served low-income families; grants were made “indiscriminately.” *Id.* at 156. A significant portion of PIC’s expenses were for marketing its programs to sellers; this marketing was handled by a for-profit company owned by the wife of PIC’s founder. *Id.* at 161.

After an audit, the IRS revoked the tax exemption for PIC and made that revocation effective as of the date of its incorporation. *Id.* at 162. The Tax Court readily sustained the determination that Partners should not be exempt. It also held that the IRS did not abuse its discretion in determining that the revocation should be retroactive to the date of incorporation because “PIC operated in a manner that was different from what it represented to the IRS in its application.” *Id.* at 172.

Because of the adverse impact that revocation can have on exempt organizations, there are some procedural protections in place in order to protect organizations from arbitrary revocations. Significantly, to

assure uniformity, every determination letter addressing exempt status is reviewed in the National Office of the IRS, which also is involved in the disposition of protests from an organization that will lose its exempt status. Treas. Reg. § 601.201(n)(4). If the organization's status is revoked, it is also entitled to challenge that decision before the Tax Court, the Court of Federal Claims, or in the U.S. District Court for the District of Columbia. I.R.C. § 7428(a).

The real lesson, however, is that careful efforts to comply with the requirements for tax-exempt status will avoid a lot of headaches; successful challenges to revocations are rare, and the process of pursuing one can be quite expensive.



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