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Losing Tax-Exempt Status

The Process In a Nutshell

It is extremely rare for an organization to lose its tax-exempt status. When it happens, it's typically the **end result** of a **three-step process**: (1) The IRS conducts an examination of the tax-exempt organization; (2) the IRS issues a letter to the organization proposing revocation; then (3) the organization exhausts all appeal rights.

Step 1 Examination

The IRS generally examines an organization's tax-exempt status after either (a) reviewing an organization's **information return**, or (b) considering information from **"any other source."**

There are certain source **limitations**, however – including a prohibition on the President and Vice President (and employees of their executive offices) from interfering in taxpayer audits and other investigations.

Step 2 Findings

If the IRS finds that the organization's determination letter should be revoked or modified, it will notify the organization of the proposed actions and the reasons for them. This notice **must** advise the organization of its opportunity to appeal the IRS' findings to the **Independent Office of Appeals** (the Appeals Office).

Step 3 Appeals

An organization can submit a **protest statement** within **30 days** of the proposed action (sometimes called a "**30-day letter**"). The 30-day letter must state that the organization is requesting the Appeals Office's consideration and the reasoning for the request. If desired, the letter can also request an appeals conference. After the review and conference, the Appeals Office will usually issue a final adverse letter or a favorable letter if requested.

If the Appeals Office issues an adverse letter, an organization may then petition the U.S. Tax Court, the U.S. Court of Federal Claims, or the U.S. District Court for the District of Columbia for a declaratory judgment on its qualification for exempt status or its classification as a private foundation/publicly supported organization.

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If Your Tax-Exempt Status Is Revoked

An organization losing its tax-exempt status does not necessarily mean the entity will cease to exist, but the organization will need to determine among a menu of options how to proceed. Working with legal counsel will be important for an organization with a revoked tax-exempt status to ensure compliance with applicable laws and mitigation of further legal risks.

What Comes After Revocation?

An organization has several options following the revocation of its exempt status, including:

- **Accept the revocation with the intent to reestablish exempt status**. If exemption was revoked due to a specific activity, the organization can (1) Halt the activity then try to reestablish exemption; (2) Move the disqualifying activity into a taxable subsidiary (or an auxiliary exempt organization) then try to reestablish exemption; or (3) Try to reestablish exemption under a different IRS Code subsection or classification under which the activity would not be disqualified.
- **Dissolve the entity**. The organization might no longer be tax-exempt, but its governing documents likely state that, upon dissolution, its remaining assets must be distributed to further of its (formerly) exempt purpose (e.g., a revoked public charity, per its organizing documents, might transfer its assets to an existing 501(c)(3) organization or a newly formed 501(c)(3), then cease operations and dissolve).
- **If a nonprofit corporation, the revoked organization can merge or consolidate into another tax-exempt nonprofit corporation**. A merger or consolidation would require a consideration of risks and extensive planning under applicable state law. For one, in addition to its assets, the surviving tax-exempt nonprofit corporation when merging with a tax-exempt organization, the surviving nonprofit corporation (the tax-exempt organization) would assume the liabilities and obligations of the other nonprofit (the organization whose exemption was revoked) organization in a merger.
- **Continue operating as a nonprofit entity that is subject to income taxes (federal and state/local, as applicable)**. Operating as a taxable nonprofit corporation or trust has different implications depending on where the entity is formed and does business or has other compliance obligations.
  If an organization chooses this option, it will need to contact state/local agencies and past donors (who may be relying on the status), and it should also any prospective donors about the status change.

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