Exempt Organizations

Any organization, including a “tax exempt” nonprofit entity, can find itself in tax debt quickly when it fails to plan transactions appropriately. In this article, Michael Miller of Merit Advisors LP gives insight on how to avoid costly sales and use tax assessments by understanding general tax law provisions, knowing when and how a nonprofit organization is exempt from tax and knowing when to ask more questions.

Exempt Organizations
Nonprofits and Sales and Use Tax: Dealing With Common Misconceptions to Avoid Liability

By Michael E. Miller

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In the last few years there have been some notable sales and use tax assessments made on nonprofits, and this has caught both administrators of these organizations and those who sell to them by surprise.

Just a few examples: A large international food distributor was hit with a surprisingly large seven-figure assessment for use tax. Another large charity hospital had a multimillion-dollar assessment for sales and use tax. A manufacturer was assessed thousands of dollars for sales made to churches and related ministries. Finally, a famous television preacher ran afoul of the sales tax laws for selling millions of dollars in tangible personal property under an invalidated “church bake sale” exemption.

Assumptions Versus Reality

When ordinary people hear about happenings like these, they seem incredible and an assumption is often made that there must have been some serious impropriety with these organizations for these things to happen. However, that isn’t the case at all. Instead, usually large assessments are simply the result of innocent mistakes based on incorrect assumptions about the law. That is all it takes for unexpected liability to be created.

This doesn’t just affect nonprofit organizations themselves, but quite to the contrary—because in reality many nonprofits are huge consumers and sellers of tangible personal property and services. Retailers, suppliers, contractors and servicemen all deal with nonprofit organizations, and the taxability of their purchases and sales can cause huge exposure issues for those businesses.

This is a modern reality, and an increasing reality at that, which often catches taxpayers completely unprepared. It is particularly important now because the number of registered nonprofits has increased in recent years. For example, between 1998 and 2008, the number of nonprofits registered with the Internal Revenue Service increased by 60 percent, according to the National Center for Charitable Statistics.

Common Misconceptions

So what are the common misconceptions that lead to such disasters in the first place? There are several, and the purpose of this article isn’t to make you, the reader, into an expert regarding every state’s tax laws as they pertain to nonprofits. Such a work would be a dictionary-sized book. Instead, my goal is to
inform you sufficiently to know that this is an issue, so that you will be informed on what questions to ask, and so that you can take the necessary due diligence to protect your company or organization from a nasty and expensive surprise.

**Misconception No. 1**

*'Being a Nonprofit or Having Section 501(c)(3) Status Means I Am Tax Exempt.'*

This is patently not true, but it is a widely held assumption, even among business professionals. The term “nonprofit” means just that for tax purposes: The entity doesn't exist to generate a profit. Whether a particular nonprofit is exempt from tax, or from which taxes it is exempt, is an entirely different matter.

An organization can be nonprofit and be taxable for a multitude of reasons. For instance, it could be nonprofit and either not be able to get qualified for tax-exempt treatment, or it could still be trying to achieve certification. Further, the entity could have lost its tax-exempt status or be engaging in nonexempt activity. There are numerous examples where nonprofit entities engage the public in a retail setting, and thereby compete with ordinary business enterprises and, therefore, engage in nonexempt (taxable) activity. This principle is nothing new, but not often fully appreciated, even by accountants.

**Misconception No. 2**

*'Being Tax Exempt Means I Am Exempt From All Taxes.'*

This is another prevalent misconception, but unfortunately “tax exempt” doesn't include each and every tax out there, nor every tax imposed by every single taxing authority.

Instead, what is commonly referred to as “tax exempt” ordinarily refers specifically to income taxes. A taxpayer can be exempt from income tax and still owe sales and use taxes, taxes on fuels, taxes on real estate, taxes on telecommunications, taxes on airfare, taxes on vehicle rentals, taxes on lodging, the list goes on and on. Because sales and use taxes are often exempted for “tax-exempt” nonprofits in many states, and because they are better known taxes than others, there is a common assumption that exempt means completely exempt from all taxes. This can be an expensive assumption.

Due diligence and prudence demand that tax professionals and business people verify the level, scope and breadth of exemptions allowed in the state where they conduct business, and for the nonprofit entities in question. There are many exceptions and exclusions that only apply to certain tax-exempt entities.

For instance, in Oklahoma churches are tax exempt for income tax purposes and for sales tax purposes to a certain degree. By way of example, a church must pay use tax on items bought with non-church funds, and must collect sales tax on items sold in the marketplace off church grounds. Contractors performing church jobs have to meet certain conditions to exempt materials from tax, and their equipment and consumables aren't exempt.

This is just a “flavor” of how sales and use taxes can affect what everyone assumes is a tax-exempt entity. (“What do you mean churches are taxable?!“)

**Misconception No. 3**

*‘Every State Basically Is the Same on This Issue. I Am Familiar With (State A) so I Should Be Fine in (States B, C and D ...).’*

This common misconception usually acts in concert with other assumptions to exacerbate the situation. In other words, often the accounting or business professional is well versed in a particular state—for
example, Texas. The state of Texas is very generous with nonprofit 501(c)(3) entities, and it often seems efficient and convenient to assume that, say, Oklahoma and Arkansas treat nonprofits the same as Texas.

In reality this is rarely the case. So again we have a common and expensive assumption. Usually they are similar in some respects, but may be totally different depending on the entity involved and the transaction in question. Yes, some 501(c)(3) organizations are exempt in Oklahoma, for instance, but not all of them. In fact only a few specific types of entities are exempt. So you can see that a Texas business person making this assumption and selling tangible personal property to nonprofits in another state without collecting tax can quickly generate a very large liability.

Just as with the prior examples, accounting professionals can't afford to make these assumptions. Accountants' and lawyers' codes of professional conduct demand that we exercise due care. The rules and requirements aren't the same state to state, and as is often the case with sales and use taxes, an ounce of prevention is worth a pound of cure.

**Misconception No. 4**

*I Just Need to Provide a Copy of My IRS Letter to Show That I Am Exempt.*

This popular misconception often exists even when the other ones are absent, and its existence can still create significant exposure. For example, a company is making sales to a nonprofit entity. The accounting professional is aware that the entity in question is exempt in his state. However, he assumes that obtaining a copy of the IRS exemption letter is sufficient to show that the entity is exempt from sales tax.

This isn't true in many instances. In fact, many states have entirely separate exemption certification letters, certificates and the like, which must be provided to render a transaction exempt. In some states the exemption certification must be obtained within a certain period of time following the transaction to even be valid. That's right, you may not be able to go back retroactively in an audit and obtain the necessary certificates in every state.

In addition, often the state-issued letters or certificates will list specific exceptions to the exemption, or requirements for it to be effective. Ignoring these requirements can and often does result in surprises in audit situations, and bear in mind that in a sales and use tax audit, it doesn't take very many of these types of “oversights” to compute to a large assessment—especially considering that interest and penalties likely will also be imposed, or that the error may be projected in a sample.

To protect your organization or your client's organizations, it is vital to understand the documentation requirements in the states in which you conduct operations, in addition to the tax theory, in order to avoid exposure.

**Misconception No. 5**

*It's a Governmental Entity! All Governments Are Exempt From Sales and Use Taxes.*

This is another expensive assumption to make. Yes, it is true that the federal government itself is exempt from state taxation based on the Supremacy Clause going all the way back to the landmark 1819 U.S. Supreme Court case *McCulloch v. Maryland*. However, often the things purchased by the federal government aren't actually acquired by a governmental entity per se, but instead a contractor working under a federal contract. This is where things get “dicey” because the various states differ widely as to when or even if a contractor can acquire things tax free under a federal contract.

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In addition to this issue, which occurs many times under audit (and usually takes taxpayers by surprise), each state has different rules about the taxability of its own political subdivisions, quasi-governmental entities, and especially other states’ governmental entities and political subdivisions. Then on top of this hodgepodge of mind-numbing complexity there are widely different rules on whether Native American tribes, public universities and their related entities, etc., must pay sales and use tax.

Suffice to say that just because your customer is a governmental entity or working pursuant to a governmental contract, doesn’t make the customer exempt from sales and use tax. Yes, many states even impose sales tax on items purchased by another state’s political subdivisions, and that isn’t including New Mexico’s “governmental gross receipts tax,” which imposes a tax collection responsibility on the state’s own state entities. In addition, depending on the state and the type of governmental entity at issue, the documentation requirements to support an exemption vary greatly between states, including everything from “no documentation required” to specific certificates and copies of governmental contracts (and everywhere in between). The basic point is that this assumption can be an expensive one, and due diligence is key. Know your state and how it addresses these issues to avoid exposure.


Recommendations and Best Practices

So what are the takeaways from this? How can you protect your company, organization or client from being one of those unfortunates that has a nasty and expensive sales and use tax surprise? In short, don’t assume.

States are beginning to recognize that nonprofits are large consumers, that they are significant taxpayers, and that they are rarely compliant with the transaction tax laws. This doesn’t just affect these entities directly—it also affects every business that does business with these nonprofit entities. While most auditors will give you a shoulder to cry on and will waive the penalty, don’t expect sympathy to result in a reduced assessment. Audit divisions are constantly trying to justify their existence and the primary way they do that is to make assessments.

Keep in mind that the charities that get nailed with this type of surprise literally feed starving children and take care of sick people. Many times they do this for free, but they don’t get much grace from the department of revenue. Consider this: If the department doesn’t give the charity much grace for being ignorant of the tax law, do you think they will give your retail shop a break when you sell taxable items to them but ignorantly fail to collect the necessary tax or certificate? Unlikely!

Assumptions are expensive when it comes to this issue, so prudence demands that you:

• Know your state.

• Know what types of entities are subject to sales and use tax.

• Know what types of activities and purchases are taxable.

• Know what kind of documentation you will need to support exempt treatment. As I mentioned before, you can understand the tax theory, but if the documentation is lacking then a liability will likely result. You may or may not be able to acquire the documentation retroactively.
As complicated and as expensive as preparation can get, the risk of an audit isn’t going away, but with some preparation and due diligence, it is a manageable risk.