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Tax-Exempt Does Not Mean Tax-Free

Nonprofits should seek pro bono counsel for tax troubles

By Robin Jacobs

There are many ways attorneys can assist struggling nonprofits during these tough economic times. Small, mission-driven nonprofits with tight finances may make two primary tax mistakes: first, overlooking a tax filing deadline, and second, choosing to pay their program bills before they pay the tax collector. Attorneys help these organizations by reviving forfeited nonstock corporations, re-applying for tax-exemption, advising nonprofits about required tax filings, and addressing penalties imposed due to failure to file taxes. These organizations often cannot afford legal advice or do not realize when legal advice may help. Lawyers play an increasingly important role in advising these organizations on tax issues, and pro bono attorneys ensure that small nonprofits that cannot afford private counsel are not left unrepresented.

First, pro bono attorneys revive nonprofit corporations that have been forfeited due to a failure to file returns or pay Maryland state tax. State tax filings are fairly minimal for organizations that hold state tax-exempt status. Every year, every nonstock corporation must file a Maryland Form 1 Personal Property Return even if they enjoy exemption from paying any personal property taxes. Failure to file this form will lead to likely forfeiture of the corporate charter. To reinstate the charter, a pro bono attorney can assist a nonprofit in filing the Articles of Revival and any missing Personal Property Returns. Without a charter, the organization cannot sign contracts or take other legal actions as a nonstock corporation. **Additionally, individual directors involved in the organization could be personally liable for actions taken while the charter is forfeited.** Attorneys help ensure that nonprofits maintain good standing with the state and file these forms on time.

Second, pro bono attorneys can also help small nonprofits that lose tax exemption re-apply for recognition of tax-exempt status from the IRS. In addition to several other benefits from tax exemption, many nonprofits rely on tax exemption to qualify for many foundation, corporate, and government grants. Legal work related to preserving tax exemption helps a nonprofit qualify for funding from diverse sources. In 2008, the IRS began requiring a 990-N tax return for small organizations, including organizations that previously did not need to file because their gross receipts did not exceed \$25,000. Organizations that fail to file the required 990-N tax return or other 990 returns for three years in a row will lose their 501(c)(3) status. Unaware of the new requirement, many small nonprofits, including over 7,000 Maryland nonprofits, are finding that they need to re-apply for tax exemption from the IRS. Pro bono attorneys can help guide them through that process, making it possible for the nonprofit to obtain grants that require exemption.

In addition to reviving forfeited corporations and re-applying for tax-exemption, pro bono attorneys may also help prevent filing charges by teaching nonprofits about their paperwork obligations to the state and the IRS. Nonprofits that fail to file their forms on time may face avoidable filing charges, further straining financing for their programs. Pro bono advice alleviates these filings costs.

Additionally, larger nonprofits with income unrelated to their charitable purpose must submit additional state and federal corporate income tax returns and pay a tax often referred to as unrelated business income tax. Depending on the size of the nonprofit, federal filings may be more complex, requiring an accountant in some circumstances.

Finally, pro bono attorneys can also guide nonprofits through the collection process when the organization owes taxes. As the State of Maryland and federal government face revenue shortfalls, collection efforts ramp up and nonprofits may not receive any leeway in that collection process. For a nonprofit organization serving the community in tough times, the board or staff may skimp on paying taxes rather than failing to meet payroll or closing their doors. Attorneys can help an organization remedy these errors, understand their tax liability exposure, and face the tough questions about whether the organization can survive the tax trouble.

Pro bono attorneys advising a nonprofit in these situations sometimes must deliver some bad news to the nonprofit. For example, even if the organization enjoys corporate protection as a nonstock entity, that protection does not protect individual, volunteer directors from responsibility for the unpaid taxes. Directors and officers liability insurance also does not usually protect against unpaid taxes. While there may be some small amount of room for the pro bono attorney to negotiate the amount due in certain cases, many state and federal collection statutes mandate procedure, interest rates, and penalties on certain types of taxes.

Attorneys, including those who serve on small nonprofit boards, should encourage nonprofits with tax troubles to seek counsel through Community Law Center's Pro Bono Program if the organization faces these tax problems or other legal issues. Nonprofits, especially small nonprofits, may lack the legal acumen to recognize legal issues when they arise. Getting an attorney involved early on may prevent legal problems from escalating.

The access to justice gap in Maryland impacts low-income organizations as well as individuals. Community Law Center's Pro Bono Program needs attorneys looking for pro bono opportunities to help serve nonprofits facing tax issues. While these nonprofits sometimes need to navigate very difficult overdue tax situations and the pro bono work is not always easy or brief, through good legal counsel, pro bono attorneys may be able to help keep a nonprofit running and serving low-income people in a time of great need. In other instances, where the case merely involves filing of overdue forms, an attorney adept at navigating bureaucracy can help organizations complete the paperwork and teach them to prevent future filing fees from accruing.

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