Follow these do's and don'ts to maintain your 501(c)(3) status

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Your status with the IRS as a tax-exempt "public charity" gives you significant benefits — paying no federal, state or local income taxes is the most obvious advantage. And the good news doesn't stop there.

The designation also enables you to receive donations, may qualify you for special grants and government funding, and can entitle you to special rates for services, such as mail delivery. In short, the status better enables your organization to apply its financial resources toward its mission and goals than if it were a for-profit entity.

But keeping your 501(c)(3) status isn't automatic. Here are some important dos and don'ts to follow if you want to retain the privilege:

Do comply with reporting obligations. Your nonprofit is required to file some type of IRS Form 990 — Form 990, Form 990-EZ or Form 990-N, depending on the amount of your total annual receipts and total assets — each year. If you fail to do so for three years in a row, your tax-exempt status will be revoked.

If you're required to file the full Form 990 or Form 990-EZ, be sure to annually complete Schedule A, Part I ("Reason for Public Charity Status") to identify why you aren't a private foundation. Check the box that coincides with the reason that you're a public charity for the current tax year.

You also must file all required payroll tax returns for your employees and 1099 forms for independent contractors, and answer related questions about these workers on your Form 990.

Do maintain the required level of public support. As detailed on Schedule A to the 990, if your nonprofit is primarily supported by a government unit or the general public or is a community trust (Box 5, 7 or 8 on Schedule A, Part I), you'll also need to pass the public support test on Part II of Schedule A. If your organization is exempt because it receives more than one-third of its support from contributions and activities related to its exempt function, as outlined in IRC Section 509(a)(2), you'll need to pass the public support test on Part III of Schedule A each year.

Do pay employment taxes and properly withhold from employees' paychecks. Even though your organization doesn't pay income taxes, you must still pay applicable employment taxes, such as the employer portion of each employee's Social Security and Medicare taxes. And you must withhold from your employees' paychecks the employee portion of employment taxes, as well as federal, state and local income taxes where applicable — and remit the withheld amounts to the appropriate governmental agency.

Do use a formal process to approve compensation. The salaries and benefits you pay your executive director and "key employees" are available to the public on your Form 990 and have been identified as a primary focus of exempt organizations' audits by the IRS. Even more important than the compensation total is the process you use to determine that the compensation is reasonable and comparable to amounts paid by organizations of similar size and activity. The IRS sees this review and approval as a responsibility of your board of directors or one of its committees.

Don't operate for the benefit of private interests. No part of a 501(c)(3) organization's earnings or equity can benefit individuals, such as the organization's founders, executives or board members — or their family members. Your nonprofit was granted its tax-exempt status to benefit the public, not private parties or interests.

Don't generate excessive unrelated business income (UBI). UBI is income from a trade or business activity that is regularly carried on and is unrelated to your exempt mission. Although the Internal Revenue Code is silent as to how much is too much, excessive UBI has been interpreted as spending a "significant" amount of time on the unrelated activity.

For example, if an organization has more expenditures for the unrelated activity than program expenses, the IRS likely will consider terminating its exempt status. But courts have considered an organization spending even as little as 10% of its total efforts on a UBI activity to be too much.

Don't pay more than market rates for goods and services. Ensure you're using your organization's resources wisely by getting at least three quotes before purchasing a significant asset or establishing a service contract or a standing order for supplies. If you ever decide to do business with related parties (board members, founders, executives or their businesses), the other quotes will support the "going rate" in your market and show you aren't providing an excess benefit to the related party.

Should the IRS determine that you've provided excess benefits, your organization and its leaders will be subject to penalties as well as the possibility of losing the nonprofit's exempt status.

Don't engage in substantial lobbying or any political campaign activities. Two methods can determine whether lobbying activities are "substantial." One considers the time spent by compensated employees and volunteers on lobbying activities. The other is the expenditure tests.

Your nonprofit can elect to use the latter option — called a 501(h) election — by filing Form 5768. (Churches are ineligible.) The 501(h) election sets a defined limit on the amount of resources an organization can use to influence legislation before losing its exempt status, based on a percentage of its total expenses.

Political campaign activities include making contributions to a political campaign fund or making public statements for or against a candidate (either written or verbal). Participating in any of these activities can result in the IRS either revoking your exempt status or imposing certain excise taxes on your organization.

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