

# State Tax Exemption Strategies



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# Super Tip #1

## 501(c)(3) status does not exempt it all....

- 501(c)(3) status only provides a charity with the ability to avoid paying income tax (and donors get a tax deduction).
- Sales and use tax exemption is a separate application to the state's department/bureau of taxation.
- Property tax exemption is a separate application – sometimes this is county-by-county, other times it is municipal or to the state body.
- Charitable gambling is a separate application to the state's regulatory body (Gambling Control Board, Attorney General's Office, etc.)
- Employment taxes are tricky (i.e., have to pay most, but 501(c)(3)s exempt from FUTA and can opt out of state unemployment insurance).
- And, watch out for Unrelated Business Income Tax (UBIT)



## Super Tip #2

### Be sure you take great care in drafting the entity's nonprofit purpose:

- The purpose is the concept that defines the breadth and depth of a nonprofit's reach. A nonprofit should be doing what its purpose says.
- The purpose is how funders, beneficiaries, other nonprofits, and government entities will understand “what” you do and “how” you fit into the rest of the nonprofit community (or whether you don't).
- The purpose, in large part, is how government entities determine whether a nonprofit entity qualifies for various forms of exemption and/or other nonprofit “benefits:”
  - Income tax exemption – 501(c) status
  - Sales and use tax exemption
  - Property tax exemption
  - Charitable gambling
  - Other benefits and exemptions
- The purpose will define whether the nonprofit entity generates UBIT.



## Drafting the Purpose

- A great purpose is a technical writing. It's not a mission statement.
- The purpose marries together the mission (which describes the programming and inspiration in flowery, marketing language) with the government's definition(s) based on the appropriate 501(c) classification and/or the appropriate "exempt purpose" category or categories (i.e., charitable, religious, educational, scientific, literary, testing for public safety, fostering national or international amateur sports competition, and preventing cruelty to children or animals).
- Use the government's "trigger words" to fit the nonprofit's purpose into established "exempt purpose" categories.
- The "trigger words" are found in the definitions. See: <http://www.irs.gov/publications/p557/> and state statutes.



## Drafting the Purpose

- NOTE: The IRS has “definitional” guidance on just about every classification and category.  
<http://www.irs.gov/publications/p557/>
- Don't forget to look at your state statutes!!



# Drafting the Purpose - Example

“Pharmacy Helpers:”

When we sat down with “Pharmacy Helpers,” the founders told us they wanted to assist people with medication affordability. We were informed that there was a gap between individuals who are Medicaid eligible and individuals who could afford medical insurance/the cost of medications. In addition, we were informed that another similar organization was already functioning in a different geographic location that we could use as a model. This third-party organization was having pharmaceuticals donated in-kind from drug companies, receiving monetary donations, and receiving in-kind donations of volunteer time in order to make their charity operate.

Here’s what we crafted for “Pharmacy Helpers:”

Pharmacy Helpers is organized exclusively for charitable, religious, educational, and scientific purposes as specified in Section 501(c)(3) of the Internal Revenue Code, or the corresponding section of a future federal tax code. This corporation shall not be operated for profit, but rather shall be operated exclusively for charitable purposes.

The specific purpose of Pharmacy Helpers is educational and charitable:

- Educational: To instruct the community and raise awareness about providing affordable prescription medications to the community’s uninsured and underinsured. This includes, but is not limited to: 1.) Helping address the gap between individual insurance coverage and a patient’s actual ability to pay for medications, as well as the community’s overall accessibility to prescriptions; 2.) Treating patients’ needs for medications through an educational, one-on-one consultative method; 3.) Promoting better health through screenings, awareness, monitoring, and referrals to other affordable health professionals as necessary; and 4.) Teaching about chronic disease prevention in reducing the need for prescription medications.
- Charitable: To lessen the burdens of government and relieve the poor, distressed, and underprivileged by providing access to critical prescription medications and on-going care for serious health care conditions.



## Drafting the Purpose - Example

### Little Free Library, Ltd.: Article III – Purpose

Little Free Library is organized exclusively for charitable, religious, educational, and scientific purposes as specified in Section 501(c)(3) of the Internal Revenue Code, or the corresponding section of a future federal tax code. This corporation shall not be operated for profit, but rather shall be operated exclusively for charitable purposes.

The specific purpose of Little Free Library is literary, educational, and charitable:

- **Literary:** To promote literacy and the love of reading by building and distributing free book exchanges worldwide;
- **Educational:** To instruct and educate the public about the importance of reading, the preservation of books, and the improvement/maintenance of reading skills; and
- **Charitable:** To foster a sense of community by sharing creativity and wisdom across generations; to combat community deterioration and juvenile delinquency; and to advance education; each being accomplished through the local distribution of free books.



# Specific Exemptions & Strategies



## State Income Tax

### State Income Tax Exemption:

- Most states have tax laws that permit their Departments/Bureaus of Revenue, once a nonprofit receives 501(c)(3) income tax exemption from the IRS, to grant income tax exemption to a nonprofit corporation.
- There's no general rule that applies in every state and city. Sometimes all nonprofit income is exempt. Sometimes it matters how the income was earned, or what it's for. Sometimes the state or local rules parallel the federal tax statutes; sometimes they are completely different.
- Each state has its own requirements for income tax exemption that should be built into the purpose statement since not all 501(c)(3) entities will qualify automatically.



## Sales and Use Tax Exemption

### Sales and Use Tax Exemption:

- Most states have tax laws that permit their Departments/Bureaus of Revenue, once a nonprofit receives 501(c)(3) income tax exemption from the IRS, to grant sales tax exemption to a nonprofit corporation.
- Sales tax exemption allows a nonprofit corporation to purchase most items necessary to accomplish its purpose without paying sales tax on those items. Most of the time, the nonprofit corporation will still need to collect and remit sales tax if it sells goods to the public. Consult with your local CPA/accountant because local sales tax rules vary widely and have lots of tricky parts.
- Each state has its own requirements for sales tax exemption that should be built into the purpose statement since not all 501(c)(3) entities will qualify.



## Sales and Use Tax Exemption

### Sales and Use Tax Exemption: Applying for Exemption

- Minnesota:  
[http://www.revenue.state.mn.us/Forms\\_and\\_Instructions/st16.pdf](http://www.revenue.state.mn.us/Forms_and_Instructions/st16.pdf)
- Ohio:  
[http://www.tax.ohio.gov/sales\\_and\\_use/information\\_releases/st200502.aspx](http://www.tax.ohio.gov/sales_and_use/information_releases/st200502.aspx)
- Illinois: <http://tax.illinois.gov/nonprofits/>
- New York:  
[http://www.tax.ny.gov/forms/sales\\_tax\\_exemption\\_documents.htm](http://www.tax.ny.gov/forms/sales_tax_exemption_documents.htm)
- California: <http://www.taxes.ca.gov/exemptbus.shtml>



# Sales and Use Tax Exemption

## Example: Minnesota's ST-16

MINNESOTA • REVENUE

ST16

### Application for Sales and Use Tax Exempt Status

Please read carefully and complete the attached application if you wish to apply for sales and use tax exempt status. Be sure to provide all the required supporting documentation requested for the organization. Applications received without the required supporting documentation will not be processed.

Under Minnesota law, some nonprofit organizations may purchase certain items without paying sales tax. These organizations must receive formal authorization from the Minnesota Department of Revenue and use Form ST3, Certificate of Exemption, in order to make tax-free purchases. The exemption applies only to purchases made by the nonprofit organization; *it does not allow the organization to sell items without collecting sales tax.*

**Note:** Nonprofit organizations that qualify for federal income tax exemption are not automatically exempt from Minnesota sales tax.

Read the list below to determine if the group is eligible for exemption from Minnesota sales and use tax.

Use this application if the group is:

- Organized and operated *exclusively* for charitable, religious or educational purposes and has obtained exemption from federal income tax under section 501(c)(3) of the Internal Revenue Code; or
- A senior citizen group that is organized for pleasure, recreation or other nonprofit purpose, not including housing. The group must be an exempt organization under 501(c) of the Internal Revenue Code and must limit membership to those who are age 55 years or older or are physically disabled; or
- A cemetery that is owned by a religious organization.

Examples of nonprofit organizations that may qualify for sales tax exempt status include churches, private schools, colleges and universities, museums and historical societies, youth organizations, senior citizen groups and volunteer fire departments.

Examples of organizations that do not qualify for sales tax exempt status include Chambers of Commerce, Knights of Columbus, Masonic Lodges, city-run celebrations, homeowners' associations, fraternities, sororities, lake improvement associations, medical clinics, Jaycees, Kiwanis and Lions Clubs, adult sports clubs of any type, trade associations, prayer societies, professional associations, senior housing organizations and social clubs.



# Sales and Use Tax Exemption

## Example: Minnesota's ST-16

Examples of organizations that do not qualify for sales tax exempt status include Chambers of Commerce, Knights of Columbus, Masonic Lodges, city-run celebrations, homeowners' associations, fraternities, sororities, lake improvement associations, medical clinics, Jaycees, Kiwanis and Lions Clubs, adult sports clubs of any type, trade associations, prayer societies, professional associations, senior housing organizations and social clubs.

**Hospitals and outpatient surgical centers generally do not qualify for sales tax exempt status, but are eligible for a separate exemption under M.S. 297A.70, subd. 7.**

### What is Exempt?

The exemption applies only to purchases of items used in the performance of the charitable, religious or educational functions of the exempt organization. The item or service must be sold directly to and paid for by the exempt organization.

The exemption does not apply in all cases. Organizations that have been granted sales tax exempt status must pay sales tax on the following:

- Building, construction or reconstruction materials purchased by a contractor or a subcontractor as part of a lump-sum contract or similar arrangement
- Construction materials purchased by the organization or a contractor to be used in constructing buildings or facilities that will not be principally used by the exempt organization
- Prepared food, candy, soft drinks, and alcoholic beverages, including catered food
- Lodging
- Gambling equipment and supplies
- Most motor vehicles
- 9.2% car rental tax and 5% car rental fee
- Waste collection and disposal services (although this is a special tax, not a sales tax)



## Property Tax Exemption

### Property Tax Exemption:

- Most states have either state-wide, municipal, or county-by-county tax laws that permit a nonprofit, once it receives 501(c)(3) income tax exemption from the IRS, to apply for property tax exemption.
- Property tax exemption allows a nonprofit corporation to purchase a piece of real property and be exempt from paying property tax on it so long as the nonprofit directly uses the real property in furtherance of its charitable purpose.
- Frequently there is an application that must be filed to claim property tax exemption and either a renewal process or spot checks by revenue agents to be sure the use of the property hasn't been changed in a way that makes it ineligible.
- Some municipalities, counties, and states do not like to forgo this income, so sometimes you need to appeal.



## Property Tax Exemption

### Property Tax Exemption: Applying for Exemption

- Minnesota: Scott County (same statutorily codified North Star test for all Minnesota counties – 6 factors)  
<http://www.co.scott.mn.us/PropertyGISLand/PropertyTaxes/Pages/ExemptStatus.aspx>
- Ohio:  
[http://www.tax.ohio.gov/portals/0/forms/real\\_property/DTE\\_DTE23\\_FI.pdf](http://www.tax.ohio.gov/portals/0/forms/real_property/DTE_DTE23_FI.pdf)
- Illinois: <http://tax.illinois.gov/publications/pios/pio-37.htm>
- New York: New York City  
[http://www.nyc.gov/html/dof/html/property/property\\_tax\\_reduc\\_non\\_profit.shtml](http://www.nyc.gov/html/dof/html/property/property_tax_reduc_non_profit.shtml)
- California: <http://www.taxes.ca.gov/exemptbus.shtml>

# Property Tax Exemption

## Example: Minnesota's Scott County

For a complete list of properties that may qualify for a property tax exemption, refer to Minnesota Statute Chapter 272, Section 02.

### **How do I know if an organization qualifies as an institution of purely public charity?**

This is a difficult question. However, in a 1975 court case, *Northstar Research Institute vs. County of Hennepin*, the Minnesota Supreme Court established five factors that are often cited as guidelines for determining if an organization qualifies as an institution of purely public charity. These five factors have been expanded to six and have since been referred to as the *Northstar Factors*.

They are:

1. Whether the stated purpose of the undertaking is to be helpful to others without immediate expectation of material reward.
2. Whether the entity involved is supported by donations and gifts in whole or in part.
3. Whether the recipients of the "charity" are required to pay for the assistance received in whole or in part.
4. Whether the income received from gifts and donations and charges to users produces a profit to the charitable institution.
5. Whether the beneficiaries of the "charity" are restricted or unrestricted and, if restricted, whether the class of persons to whom the charity is made available is one having a reasonable relationship to the charitable objectives and,
6. Whether the dividends, in form or substance, or assets upon dissolution are available to private interest.

Please complete **North Star Factor Survey** when applying for exempt status. 

### **How do I apply for a property tax exemption?**

All owners applying for a property tax exemption must file an application for exemption with the Scott County Assessor. Documents that may be requested are:

- Application for Property Tax Exemption
- Deed(s) to the property
- Articles of Incorporation
- A letter from the Internal Revenue Service granting tax exempt status under Internal Revenue Code 501(c)3
- Income & Expense statements and IRS Form 990
- Leases or other agreements for space used by individuals or other entities
- A detailed written explanation of all current and intended uses of the property
- Minnesota Department of Revenue Exempt Status
- Proof of Charitable Contributions
- Proof of Purely Public Charity Institutions
- Other documents and records unique to a specific property



# Charitable Gambling

## Charitable Gambling:

- If a nonprofit wishes to participate in charitable gambling as a fundraising mechanism, most states have statutory requirements in order to qualify for licenses/permits.
- Charitable gambling, sometimes called lawful gambling, routinely includes the following items:
  - Raffles
  - Bingo
  - Instant Bingo/Pulltabs
  - Paddlewheels
  - Tipboards
  - Electronic games
  - Some jurisdictions allow games of skill and/or games of chance in certain circumstances (consult the local laws)
- Usually silent auctions and door prizes are exempt from government scrutiny.
- Beware of live auctions: Often these are regulated by the state, and require the auctioneer to be licensed.



## Charitable Gambling

### Charitable Gambling: Applying for Licenses

- Minnesota: <http://mn.gov/gcb/AllForms.htm>
- Ohio:  
<http://www.ohioattorneygeneral.gov/BingoLicense>
- Illinois: <http://tax.illinois.gov/charitygaming/>
- New York:  
<http://www.gaming.ny.gov/charitablegaming/>
- California:  
<https://oag.ca.gov/gambling/charitable>



# Charitable Gambling

## Example: Minnesota's LG200A – New Organization License Application

### Check List for Licenses and Premises Permit

To conduct lawful gambling in Minnesota, your organization must apply for and receive:

- 1) an organization license,
- 2) a gambling manager license, and
- 3) at least one premises permit.

Use this checklist to complete the required attachments to each application.

#### **LG200A Organization License Application and the following attachments.**

- LG200B Organization Officers Affidavit - for CEO and treasurer
- LG200C - For 501(c)(3) organizations and 501(c)(4) festival organizations only
- Proof of nonprofit status
- Organization by-laws; signed by your chief executive officer
- Membership list showing at least 15 active members including date of membership for each member; list signed by your chief executive officer
- LG209 Registration of Paid Gambling Employee
- \$350 annual license fee (non refundable). Make check payable to "State of Minnesota."

FEE WAIVER: If your organization receives less than \$100,000 in gross annual receipts, you may request a waiver of the organization license fee after your first licensed year.



## Employment Taxes/Insurance

### Employment Taxes/Insurance:

- The IRS informs us that if a tax-exempt organization (EO) has employees, the EO is responsible for Federal Income Tax Withholding and Social Security and Medicare taxes.
- In addition, some EOs are responsible for Federal Unemployment Tax (only 501(c)(3)s are exempt – all other 501(c) types are not exempt).
- Remember: Employment taxes are for nonprofit organizations with EMPLOYEES. To determine whether your worker is an employee or an independent contractor, see: <http://www.irs.gov/Charities-&-Non-Profits/Exempt-Organizations:-Independent-Contractors-vs.-Employees>.



# Employment Taxes/Insurance

Employment Taxes/Insurance: The IRS tells us the following about payroll taxes for exempt organizations

- If the organization has employees, it is responsible for several federal, state, and local payroll taxes. As an employer, the organization must withhold certain taxes from employees' pay checks. Employment taxes include the following:
  - Federal income tax withholding (FITW)
  - Social Security and Medicare taxes (FICA)
  - Federal unemployment taxes (FUTA)
- FITW/FICA: An organization generally must withhold federal income tax from its employees' wages. The organization, as the employer, must withhold and deposit the employee's part of the taxes and pay a matching amount. The Social Security tax is withheld from the employee's gross wages until the employee's cumulative wages for the year reach the wage base limit. Wages above the wage base limit are not subject to Social Security tax withholding. However, there is no wage base limit for Medicare tax; all covered wages are subject to Medicare tax.
- FUTA: The federal unemployment tax is part of the federal and state program under the Federal Unemployment Tax Act (FUTA) that pays unemployment compensation to workers who lose their jobs. The federal unemployment program was enacted to encourage states to provide payment to workers who have lost their jobs. FUTA tax should be reported and paid separately from FICA and FITW. FUTA tax is paid only from an organization's own fund. Employees do not pay this tax or have it withheld from their pay. An organization that is exempt from income tax under section 501(c)(3) of the Internal Revenue Code is also exempt from FUTA. This exemption cannot be waived. An organization that is not a section 501(c)(3) organization is not exempt from paying FUTA tax.
- From March 19, 2010 to December 31, 2010, a payroll tax exemption existed for the employer's 6.2 percent share of social security tax on all wages paid to qualified employees. This was part of the now expired HIRE Act. The employee's 6.2 percent share of social security tax and the employer and employee's shares of Medicare tax still applied to all wages during this period.
- Payroll tax exemption resources:
  - <http://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/FAQs-About-the-Payroll-Tax-Exemption-and-Qualified-Employers>
  - <http://www.irs.gov/Charities-&-Non-Profits/Employment-Taxes-for-Exempt-Organizations>
  - <http://www.irs.gov/Charities-&-Non-Profits/Exempt-Organizations:-What-Are-Employment-Taxes%3F>



# Employment Taxes/Insurance

## Employment Taxes/Insurance: State Unemployment Insurance

- Recall that 501(c)(3) tax exempt organizations are exempt from FUTA.
- In addition, most states allow nonprofit corporations to opt out of state unemployment insurance.

See:

- <http://www.nolo.com/legal-encyclopedia/should-your-nonprofit-participate-its-state-unemployment-insurance-program.html>
- <https://www.guidestar.org/rxa/news/articles/2005/alternatives-to-unemployment-taxes-for-501c3.aspx>:
  - ✓ Advantages to paying state unemployment tax: A tax-paying employer knows the tax rate for the coming year and can project the annual cost based on their taxable payroll. If your claims were more than your taxes, the state unemployment department will still cover the claims (but you can probably expect a tax increase in subsequent years). During the past two-three years of unusually high unemployment, paying state taxes has provided good security for agencies that experienced funding cuts and decreased donation dollars.
  - ✓ Disadvantages to paying state unemployment tax: Depending on the state, unemployment taxes currently range from .1 percent to 10.96 percent on each employee's taxable wages, which vary from \$7,000 to \$31,000 per employee. Although unemployment stabilized in 2004, unemployment taxes still increased in many states in 2005 because those states must rebuild their depleted SUI pools. This situation means a nonprofit is probably paying much more in taxes than the state is paying for its claims. *Nationally, nonprofits typically pay \$2.20 in taxes for every \$1 in claims.*



## Employment Taxes/Insurance

- And, remember that nonprofit organizations and government entities are allowed to have volunteers (unpaid help) – for-profits are NOT.
- See: U.S. Dept. of Labor Fact Sheet #71:  
Internship Programs Under The Fair Labor Standards Act

<http://www.dol.gov/whd/regs/compliance/whdfs71.pdf>



## Avoid UBIT

### Prevent Unrelated Business Income Tax (UBIT): Exemption obstacle

- The purpose is the tool that helps the IRS determine whether a nonprofit is subject to Unrelated Business Income Tax, or UBIT. It's pronounced "you-bit".
- Organizations that are exempt from paying United States corporate tax on income related to their exempt purposes must, nevertheless, pay tax at the standard corporate tax rates for any unrelated business income over \$1,000 per year. This is done by filing the Form 990-T.
- Earning unrelated business income does not in itself call into question an organization's tax-exempt status. The IRS may, however, question an organization where UBI makes up a very large proportion of its total revenue.
- Pursuant to IRS Publication 598, “Unrelated business income is the income from a trade or business regularly carried on by an exempt organization and not substantially related to the performance by the organization of its exempt purpose or function, except that the organization uses the profits derived from this activity.”
- See: <http://www.irs.gov/pub/irs-pdf/p598.pdf>, p.3.



## Avoid UBIT

- To determine whether a business activity is (or is not) substantially related requires an examination of the relationship between the business activities which generate the particular income in question—that is, the activities of producing or distributing the goods or performing the services involved—and the accomplishment of the organization’s exempt purpose.
- To be related, in the statutory sense, the relationship must be causal. In addition, the causal relationship must be a substantial one. Thus, the activities which generate the income must contribute importantly to the accomplishment of the organization’s exempt purposes to be substantially related. Regs. 1.513–1(d). Whether activities productive of gross income contribute importantly to the accomplishment of any purpose for which an organization is granted exemption, depends in each case upon the facts and circumstances involved. Income derived by an exempt organization is not taxed as commercial activity if the income-generating activity contributes importantly to the tax exempt purposes of the organization. IRC § 513(a); Rev. Rul. 75-472, 1975-2 C.B. 208.
- Example: Humane Society and grooming/boarding lines of business, or a church located next to stadium renting out its parking spots.

# Thank you!!!



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