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State Regulations Affecting Tax-Exempt Charitable Organizations

Prepared

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**STATE REGULATION
AFFECTING
TAX-EXEMPT CHARITABLE ORGANIZATIONS**

Checklist of State Registration/Regulation Issues

1. Authority to do business
2. Tax exempt status (state income tax)
3. Sales/Use tax
 - a. Selling
 - b. Buying
4. Property Tax
5. Employment
 - a. Income Tax Withholding
 - b. Unemployment
 - c. Workers' Comp
6. Charitable Trust and Solicitation
7. Charitable Gift Annuities
8. Charitable Gaming or Gambling

This article provides guidance for non-for-profit organizations and on the above checklist issues. Given the wide variety of tax-exempt organizations and the fact that every state has differing regulations and registration requirements, this article will focus on Illinois regulations applicable to 501(c)(3) organizations.

I. AUTHORITY TO DO BUSINESS

A corporation has authority to do business within its state of incorporation when it incorporates under the laws of that state. If the corporation has enough activity within other states to constitute “doing business” within those states, it will need to file for a certificate of authority and comply with periodic reporting requirements within those states. A non-Illinois (or “foreign”) corporation doing business here must file for a certificate of authority to do business in Illinois under 805 ILCS 105/113.05 and must subsequently file annual reports with the Secretary of State (as must any domestic not-for-profit corporation) pursuant to 805 ILCS 105/114.05.

The Illinois form for a foreign not-for-profit corporation doing business within Illinois can be found at: http://www.sos.state.il.us/publications/pdf_publications/nfp11315.pdf

II. EXEMPTION FROM STATE INCOME TAX

States vary in their approach to exemption from state income tax. Some, like Illinois, make the exemption from state income tax automatically apply to organizations that the IRS has determined to be exempt from federal income tax. Others require a filing in order to recognize that exemption. A few states have no state income tax. In Illinois, the exemption follows the federal exemption and is automatic:

- A. Pursuant to 35 ILCS 5/205, income which is exempt under Section 501(a) of the Internal Revenue Code is exempt from Illinois income tax.
- B. Unrelated taxable income under Section 512 of the IRC is taxable.

III. REGISTRATION FOR OR EXEMPTION FROM SALES/USE TAX

A common mistake made by tax exempt organizations is to assume that being “tax exempt” means they are exempt from collecting and remitting state sales and use taxes. States vary widely in terms of their approach to sales and use taxes and whether or not exemptions apply to federally tax exempt organizations. All but a handful of states have a sales/use tax. A few states grant exemptions broadly, but most grant exemptions narrowly if at all. A few states grant an exemption to tax exempt organizations that make retail sales, and more states tend to grant an exemption to tax exempt organizations for their purchases. When reviewing the exemptions under various state laws, it is apparent that sales and use tax exemptions are the result of local priorities and political forces.

As background, Illinois has four related sales/use taxes:

- (1) Retailer’s Occupational Tax Act 35 ILCS 120/1 *et seq.*;
- (2) Service Occupational Tax Act 35 ILCS 115/1 *et seq.*;
- (3) Use Tax Act 35 ILCS 105/1 *et seq.*; and
- (4) Service Use Tax Act 35 ILCS 110/1 *et. seq.*

A. RETAILING

Generally, nonprofits engaged in regular retail sales of goods or services in Illinois are required to register with the Department of Revenue (using the REG-1 form) and to collect and remit sales taxes. Registration Requirements are described in 35 ILCS 120/2a. The form can be downloaded at: <http://www.revenue.state.il.us/taxforms/reg/reg1.pdf>

Some specific exemptions are provided and described below.

What can the organization do if it should have been collecting and remitting sales taxes but failed to do so? The Illinois Department of Revenue has a Voluntary Disclosure process. If the organization qualifies, its back-tax liability will be limited to four years, and penalties (but not interest) will be waived. The initial application in the process is made on form BOA-1. This form can be downloaded at: <http://www.revenue.state.il.us/taxforms/Misc/Boa/boa1.pdf>. Nearly every other state has a similar voluntary disclosure process available.

B. CONSUMING

Non-profits making purchases may qualify for exemption from Retailer's Occupational Tax under 35 ILCS 120/2-5(11). The requirements of the application for a Certificate of Exemption are found at 86 Ill Adm. Code 130:2007. There is no standard form for this application. However, all sales tax exemption applications must meet the standards developed by the Illinois Supreme Court in *Methodist Old Peoples Home v. Korzen*, 39 Ill. 2d 149 (1968) as to what constitutes an "institution of public charity".

C. TRANSACTIONAL EXEMPTIONS

Certain transactional exemptions are applicable to all, not just not-for-profit corporations. Some of these are found at 86 Ill Adm. Code 130:120, and include:

1. Occasional or isolated sales 86 Ill Adm. Code 130:110.
2. Newspapers, magazines, books, sheet music and phonograph records if they are individualized and generally not available through commercial channels. 86 Ill Adm. Code 130:2105.
3. Transfers to any corporation, society, association etc., operated exclusively for charitable religious or educational purposes. 35 ILCS 120/2-5 Subsections (6), (9) and (11).
4. Sales by teachers-sponsored student organizations affiliated with elementary or secondary schools located in Illinois. 86 Ill Adm. Code 130:2006. Must have certificate of resale.

In addition, certain sales by tax-exempt organizations may be exempt under the provisions of 86 Ill Adm. Code 130.2005. These include the following:

1. Sales to members, patients, students (except for the sale of text books to students by schools).

2. Occasional sales, i.e. benefit dinners, rummage sales, etc., if not more than twice a year.
3. Noncompetitive sales like scout cookies, Christmas trees, calendars, etc. sold at infrequent fundraising events.
 - a. Conducted by members and not by franchises or licensee
 - b. All proceeds to charity
 - c. Transaction is not continuing, only a few times per year
 - d. Purchaser's dominant motive is donative

IV. PROPERTY TAX EXEMPTION 35 ILCS 200/15-5

When an exempt organization owns and uses property for exempt purposes it may apply for property tax exemption.

- A. Section 200/15 contains numerous exempt uses. A few that are relevant to this discussion include:
 1. Charitable purposes 35 ILCS 200/15-65
 2. School property 35 ILCS 200/15-35
 3. Religious purposes 35 ILCS 200/15-40
 4. Parking lots of the above 35 ILCS 200/15-125
- B. Tests Concerning Tax Exempt Status
 1. Charitable - Methodist Old Peoples Home v. Korzen 39 Ill 2d 149 (1968)
 2. Schools - Coyn Electrical School v. Pashen 12 Ill.2d 387 (1957)
 3. Religious - People ex rel. Bracher v. Salvation Army, 305 Ill. 545, 137 N.E. 430 (1922)
- C. The exemption process is described in 86 Ill Adm. Code 110.115 using forms PTAX-300 or PTAX-300R for religious exemptions. These forms are available at <http://www.revenue.state.il.us/RETD>. The Cook County board of appeals also has its own form.

V. EMPLOYMENT ISSUES

A. WITHHOLDING (INCOME TAX FROM EMPLOYEES)

An employer is required to comply with the Withholding Tax requirements in Article 7 (35 ILCS 5/701 *et seq.*) of the Illinois Income Tax Act. A new entity should register with the Illinois Department of Revenue using form REG-1.

B. UNEMPLOYMENT INSURANCE ACT 820 ILCS 405/

Section 3306 (c) (8) of the Federal Unemployment Tax Act excludes services performed in the employ of a religious, charitable, educational, or other organization described in section 501(c)(3) which is exempt from income tax under section 501(a).

The Illinois Act (and the similar acts of most states) defines “employment” to include the services in the employ of a nonprofit organization “which has or had in employment 4 or more individuals within each of 20 or more calendar weeks (but not necessarily simultaneously and irrespective of whether the same individuals are or were employed in each such week), whether or not such weeks are or were consecutive, within either the current or preceding calendar year.” 820 ILCS 405/211.2. Some other kinds of employers are excluded under 820 ILCS 405/211.3 including churches and their schools.

Therefore, nonprofit employers that are exempt under IRC 501(c)(3) are not required to register until they have 4 or more paid workers in Illinois within each of 20 or more calendar weeks during a year. Form UI-1 is used for the initial registration. This form is available at <http://www.ides.state.il.us/forms/enabled/UI1.pdf>.

Once registered, nonprofits have the option to elect to be a reimbursable employer. If the organization so elects, the Department will send Form UC-5(NP) for completion. Exempt organizations can voluntarily elect coverage under the program if they have fewer than 4 employees. If they so choose, they will need to complete Form UI-1B which the Department will mail to the applicant.

The Illinois Department of Employment Security page containing employer information is found at: <http://www.ides.state.il.us/employer/uitax/index.htm>.

C. WORKERS’ COMPENSATION ACT 820 ILCS 305/

There are no exemptions for nonprofit employers under the Illinois Workers’ Compensation Act. It is therefore recommended that organizations obtain insurance.

VI. CHARITABLE FUND-RAISING

A. The Illinois Charitable Trust Act 760 ILCS 55/

The Charitable Trust Act, 760 ILCS 55 provides for regulation of all property in this state held for charitable purposes. The regulatory scheme includes a registration procedure for all charitable trusts and a regular annual reporting requirement for most trustees holding significant charitable assets. Section 55/4 excludes all federal, state and local municipal governmental agencies from coverage under the Act, as well as corporations sole, and other religious corporations, trusts or organizations which hold property for religious, charitable, hospital or educational purposes or for operating cemeteries or homes for the aged.

The basic registration statement is Form CO-1. Organizations with minimal assets may

file Form CO-2 to obtain exemption from further filing requirements. Religious organizations may obtain exemption upon filing Form CO-3. Nearly all trustees that are registered under this Act are required to file Form AG 990-IL within six months following the end of the fiscal year. The trustee is required to include a copy of the Federal 990 with the AG 990-IL. These forms are available at the Attorney General's website at www.ag.state.il.us/charities/register_report.html.

B. The Illinois Solicitation for Charity Act

The Solicitations for Charity Act, 225 ILCS 460 functions as a corollary to the Charitable Trust Act. Section 460/2 requires nearly all charitable organizations that intend to solicit charitable contributions in Illinois to register with the Attorney General on forms prescribed by that office. Section 460/3 describes a number of organizations that are exempt from the registration requirement for a variety of reasons. Religious entities and other charitable organizations that do not receive more than \$15,000 per year may be generally exempted from the registration requirements provided they submit registration forms so that the Attorney General can make an exempt determination.

All charitable organizations that are required to be registered under this act and which receive more than \$150,000 during the fiscal year must file a written report of income and expenses with the Attorney General within six months following the end of the fiscal year. The report must be accompanied by the opinion of a CPA. The prescribed form for this report is the AG 990-IL, and filers must also include a copy of their IRS Form 990. This provision is similar to the Charitable Trust Act.

C. Web resources:

Illinois Attorney General's charitable trust page (detailed filing requirements and downloadable forms): <http://www.ag.state.il.us/charitable/charity.html>

The site of the National Association of State Charity Officers (links to other states and the unified registration form): <http://www.nasconet.org>

VII. CHARITABLE GIFT ANNUITIES

Various states regulate Charitable Gift Annuities. A few states require advance registration and compliance with specific rules which often include: an application, annual filings, filing copies of agreements, specified number of years of operation, disclosure language in documents, maintenance of specified reserves, and specific investment limitations.

Illinois does not require registration but has some specific requirements. The applicable law is found in the Illinois Insurance Code at 215 ILCS 5/121-2.10.

“The insurance laws of this State, including this Code, do not apply to any charitable gift annuity, as defined in Section 501(m)(5) of the Internal Revenue Code, issued by an

organization that is described in Section 170(c) of the Internal Revenue Code, if either (i) an insurer authorized to transact business in this State is directly obligated to the annuitant or (ii) the organization has been in active operation for not less than 20 years before the date the annuity is issued and has an unrestricted fund balance of not less than \$2,000,000 on the date the annuity is issued.”

VIII. CHARITABLE GAMING AND GAMBLING

- A. Raffles Act 230 ILCS 15/
- B. Illinois Pull Tabs and Jar Games Act 230 ILCS 20/
- C. Bingo License and Tax Act 230 ILCS 25/
- D. Charitable Games Act 230 ILCS 30/

These four Acts regulate certain gambling activities of nonprofit organizations. Income from the activities may be taxable. Each Act should be carefully reviewed if the organization is considering engaging in such activities.

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