

Threats to Nonprofits Targeting Tax-Exempt Status

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Today's Discussion

Current events and threats to nonprofits' tax-exempt status

Process and basis for revocation of tax-exempt status

Illegality and public policy doctrines

Terrorist-supporting organization legislation

Current Events and Threats to Tax-Exempt Status

New administration has asserted a substantial shift in the approach to certain policy issues through executive orders and other actions that could affect tax-exempt organizations' purposes and activities:

- Diversity, equity, and inclusion
- Climate
- Immigration
- Gender
- LGBTQIA+

Congressional hearings focused on protests on college campuses following the October 7, 2023 attack on Israel by Hamas, which gave rise to proposed legislation permitting the treasury secretary to revoke the tax-exempt status of terrorist-supporting organizations

The president has threatened to revoke the tax-exempt status of Harvard and other universities

How Exempt-Status Could Be Revoked

After an IRS examination (audit)

But IRS Revenue Procedure governing determination letters states that determination letters may be revoked or modified by:

- a notice sent to the organization
- enactment of legislation
- ratification of a tax treaty
- a decision of the U.S. Supreme Court
- issuance of temporary or final regulations or
- issuance of a revenue ruling, revenue procedure, or other statement published in the Internal Revenue Bulletin

See Rev. Proc. 2025-5, § 12.

How Organizations Are Selected for Examination

Compliance strategies:

- IRS initiatives targeting specific areas of concern
- TE/GE exempt organizations work plan for FY25 is focused on Form 990N filers; excise taxes on excess compensation under IRC §4960; tax-exempt hospitals; and tax-exempt collectives using name, image, and likeness (NIL) agreements with student athletes

Referrals, claims, other casework:

- Complaints or referrals can come from the public, government agencies, or other sources
- Form 13909—Tax-Exempt Organization Complaint (Referral)

Data-driven approaches

- Information flagged from Forms 990
- Inconsistent or incomplete information in a filed return
- Financial irregularities or discrepancies, unreasonable compensation, excess benefit transactions, diverted assets, substantial unrelated business income

IRS Exams—Recent Statistics

In FY 2023:

- 2,529 exams started (232 compliance strategies; 790 data-driven; 1,507 referrals, claims, and other casework)
- 2,464 exams closed (221 compliance strategies; 746 data-driven; 1,497 referrals, claims, and other casework)
- 141 revocations
 - 124—operational requirements
 - 26—filing requirements
 - 16—organizational requirements
 - 16—unrelated business income
 - 9—Chapter 42 taxes (private foundation excise taxes)
- 541 Exempt Organizations Division employees

IRS Compliance Projects

IRS compliance projects have focused on:

- Colleges and universities
- Hospitals
- Credit counseling organizations
- Housing counseling and foreclosure prevention

Typically begin with a questionnaire and lead to IRS exams

Common Issues in Exams

Organizational and operational requirements

- Substantial non-exempt purposes or activities
- Private inurement or private benefit
- Lobbying and political activities

Unrelated business income

Executive compensation

Employment taxes

Less common: illegality, violation of established public policy

Illegality Doctrine

Common law concept derived from English charitable trust law principles; recognized in *Bob Jones* case (next slide)

An organization may not qualify for tax-exempt status if it has an **illegal purpose** or if it **engages in substantial illegal activities**; illegal activities do not further an exempt purpose

- Substantiality is measured from a qualitative and quantitative perspective
 - Quantitative = time and attention
 - Qualitative = seriousness, intentionality

Illegality Doctrine (cont.)

Examples of determinations relying on illegality doctrine have included groups engaged in:

Civil disobedience

- Rev. Rul. 75-384

Use or distribution of illegal drugs

- Priv. Ltr. Rul. 201224036 (marijuana)
- Priv. Ltr. Rul. 2020014019 (marijuana)
- *Iowaska Church of Healing v. Werfel*, No. 23-5122 (D.C. Cir. June 21, 2024) (Ayahuasca)

Tax fraud conspiracy

- *Church of Scientology of California v. Commissioner*, 83 T.C. 381 (1984)

Plural marriage

- Priv. Ltr. Rul. 201310047

Decriminalizing/reforming law concerning sexual exploitation of children

- *Mysteryboy Inc. v. Commissioner*, T.C. Memo 2010-13

Public Policy Doctrine

U.S. Supreme Court in *Bob Jones University v. United States*, 461 U.S. 574, upheld the IRS's revocation of Bob Jones University's 501(c)(3) tax-exempt status due to the school's policy denying admission to persons engaged in or known to advocate for interracial marriage or dating

The Court explained:

- a charitable organization's purpose "may not be illegal or **violate established public policy**"
- "determinations of public benefit and public policy are sensitive matters with serious implications for the institutions affected" and
- a "declaration that a given institution is not 'charitable' should be made only where there can be no doubt that the activity involved is contrary to a fundamental public policy."

What exactly constitutes "fundamental public policy" is not clearly defined, but the Court looked to actions of all three branches of the federal government over three decades to conclude that racial discrimination in education "violates a most fundamental national public policy"

PSLF Order and “Substantial Illegal Purpose”

Public Service Loan Forgiveness Program—March 7, 2025 Presidential Order:

Directs the Secretary of Education and Secretary of the Treasury to propose revisions to the regulations governing the PSLF program to “ensure the definition of ‘public service’ excludes organizations that engage in activities that have a ‘substantial illegal purpose’ including:

- aiding or abetting violations of 8 U.S.C. 1325 or other Federal immigration laws;
- supporting terrorism, including by facilitating funding to, or the operations of, cartels designated as Foreign Terrorist Organizations consistent with 8 U.S.C. 1189, or by engaging in violence for the purpose of obstructing or influencing Federal Government policy;
- child abuse, including the chemical and surgical castration or mutilation of children or the trafficking of children to so-called transgender sanctuary States for purposes of emancipation from their lawful parents, in violation of applicable law;
- engaging in a pattern of aiding and abetting illegal discrimination; or
- engaging in a pattern of violating State tort laws, including laws against trespassing, disorderly conduct, public nuisance, vandalism, and obstruction of highways.”

What Does This Mean for DEI Activities?

Executive orders do not change the law.

Federal Anti-Discrimination Laws:

- Title VII of the Civil Rights Act of 1964: Prohibits discrimination in employment on the basis of race, color, religion, sex, or national origin.
- Other Federally Protected Categories in Employment
 - Disability (Americans with Disabilities Act)
 - Age over 40 (Age Discrimination in Employment Act)
 - Genetic Information (Genetic Information Nondiscrimination Act)
 - Military Service (Uniformed Services Employment and Reemployment Rights Act)
- Title VI of the Civil Rights Act of 1964: Prohibits discrimination on the basis of race, color, or national origin. Applies only to organizations that receive federal financial assistance.
- Title IX of the Education Amendments of 1972: States that “[n]o person in the United States shall, on the basis of sex, be excluded from participation in, be denied the benefits of, or be subjected to discrimination under any education program or activity receiving Federal financial assistance.”
- Section 1981 of the Civil Rights Act of 1866: Prohibits race discrimination in contracts.

What Does This Mean for DEI Activities? (cont.)

- No clarity about how Section 1981 claims would fare—courts have only ruled on injunction claims—still, trend points to a more restrictive environment
- Section 1981 language gives all citizens same rights as white citizens in contracts; does not address gender, sex, sexual orientation
- Other forms of “invidious discrimination” may be overturned on other theories (not Section 1981)—common law charitable trust doctrine, for example
- Note Civil Rights Act Section 1982—“All citizens of the United States shall have the same right ... as is enjoyed by white citizens thereof to inherit, purchase, lease, sell, hold, and convey real and personal property.”
- Not all programs are the same:
 - Scholarships and grants
 - Awards
 - Affinity groups
 - Advocacy

H.R. 9495, Stop Terror-Financing and Tax Penalties on American Hostages Act

Bill Status

- Passed in the House on Nov. 21, 2024 by a vote of 219-184
 - 204 Republicans and 15 Democrats voted in favor
 - 1 Republican and 183 Democrats voted against
- Was not taken up by the Senate before the end of the 118th Congress
- Similar to H.R. 6408, which passed the House in April 2024 by a vote of 382-11
- Has not yet been reintroduced as stand-alone legislation in the 119th Congress, but similar provisions were included in draft of this year's budget reconciliation bill (ultimately stripped out prior to passage)

Original Sponsors:

- Rep. Claudia Tenney (R-NY-24)
- Rep. David Kustoff (R-TN-8)
- Rep. Brad Schneider (D-IL-10)
- Rep. Dina Titus (D-NV-1)

H.R. 9495, Stop Terror-Financing and Tax Penalties on American Hostages Act (cont.)

Key Provisions of H.R. 9495:

- Extends tax deadlines and waives tax penalties for Americans held hostage abroad and their spouses
- Amends Section 501(p) of the Internal Revenue Code to add a new paragraph (8) that would allow the Treasury Secretary to designate a tax-exempt organization as a **terrorist-supporting organization** and **suspend the organization's tax-exempt status** if upon 90 days' notice:
 - the organization does not demonstrate to the satisfaction of the Secretary that the organization either
 - did not provide material support or resources to a designated terrorist organization or
 - made reasonable efforts to have any such material support or resources returned with a certification that the organization will not provide any further material support or resources to designated terrorist organizations

H.R. 9495, Stop Terror-Financing and Tax Penalties on American Hostages Act (cont.)

H.R. 9495 would broaden I.R.C. § 501(p) to allow for suspension of tax-exempt status of not just designated terrorist organizations, but of organizations deemed by the Treasury Secretary to have provided material support or resources to a designated terrorist organization

It is already illegal for any person to knowingly provide material support to a designated terrorist organization. *See, e.g.*, 18 U.S.C. § 2339B.

According to the House Ways and Means Committee Report on H.R. 9495:

- The Ways and Means Committee held hearings about protests on college campuses following the October 7, 2023 attack on Israel by Hamas
- “The Committee recently received testimony about links between domestic organizations with tax-exempt status and international terrorist organizations and believes the IRC should not be used to subsidize or finance violent terrorism around the world.”
- “Under current law, an entity's tax-exempt status may be suspended if it is designated by the U.S. Department of State as a terrorist organization, but current law does not allow the IRS to suspend the tax-exempt status of organizations identified as having provided material support or resources to a designated terrorist or terrorist-supporting organization.”

H.R. 9495, Stop Terror-Financing and Tax Penalties on American Hostages Act (cont.)

I.R.C. § 501(p) currently suspends the tax-exempt status of any organization that has been designated as a terrorist organization under:

- Under Section 212(a)(3)(B)(vi)(II) or 219 of the Immigration and Nationality Act
- In or pursuant to an executive order related to terrorism and issued under the authority of the International Emergency Economic Powers Act or Section 5 of the United Nations Participation Act of 1945 for the purpose of imposing an economic or other sanction
- In or pursuant to an Executive order issued under the authority of any Federal law if the organization is designated in or pursuant to the Executive order as supporting or engaging in terrorist activity as defined in Section 212(a)(3)(B) of the Immigration and Nationality Act or supporting terrorism as defined in Section 140(d)(2) of the Foreign Relations Authorization Act, Fiscal years 1988 and 1989, and such Executive order refers to I.R.C. § 501(p)

from the date of the designation until the date the designations have been rescinded under law.

I.R.C. § 501(p)(5) currently denies any challenge or appeal of the suspension of tax-exempt status or the designation as a terrorist organization in any administrative or judicial proceeding relating to the Federal tax liability of the organization or other person

H.R. 9495, Stop Terror-Financing and Tax Penalties on American Hostages Act (cont.)

What is a **terrorist-supporting organization** under the bill?

- Any organization that is designated by the Treasury Secretary as having provided, during the 3-year period ending on the date of such designation, **material support or resources** (within the meaning of 18 U.S.C. § 2339B) **to a terrorist organization** designated under the authorities listed in I.R.C. § 501(p)(2)

How is **material support or resources** defined?

- Has the meaning in 18 U.S.C. § 2339B
 - Any property, tangible or intangible, or service, including currency or monetary instruments or financial securities, financial services, lodging, training, expert advice or assistance, safehouses, false documentation or identification, communications equipment, facilities, weapons, lethal substances, explosives, personnel (1 or more individuals who may be or include oneself), and transportation, except medicine or religious materials
 - *See also Holder v. Humanitarian Law Project*, 561 U.S. 1 (2010)

H.R. 9495, Stop Terror-Financing and Tax Penalties on American Hostages Act (cont.)

Before designating an organization as a terrorist-supporting organization, the Treasury Secretary must provide the organization with **written notice**, which:

- Provides a 90-day period to “cure” (i.e., prove to the Secretary’s satisfaction it did not provide material support or resources to a terrorist organization)
- Identifies the name of the terrorist organization the Secretary has determined was provided with material support or resources
- Describes the material support or resources the Secretary has determined were provided, to the extent consistent with national security and law enforcement interests

H.R. 9495, Stop Terror-Financing and Tax Penalties on American Hostages Act (cont.)

Bill includes options for appealing a terrorist-supporting organization designation:

- Administrative review by IRS Independent Office of Appeals
 - A dispute over the Treasury Secretary's designation of an organization as a terrorist-supporting organization is subject to resolution by the IRS Independent Office of Appeals under IRC § 7803(e) in the same manner as if the designation were made by the IRS
- Federal litigation
 - The United States district courts shall have exclusive jurisdiction to review a final determination with respect to an organization's designation as a terrorist-supporting organization
 - A determination with respect to an organization's designation as a terrorist-supporting organization will not fail to be treated as a final determination merely because the organization fails to utilize the dispute resolution process of the IRS Independent Office of Appeals

H.R. 9495, Stop Terror-Financing and Tax Penalties on American Hostages Act (cont.)

Concerns:

- Designation is entirely within the discretion of the Treasury Secretary
- No requirements regarding what evidence the Secretary may consider or rely on in making a designation or requirements for the Secretary to provide the organization with the evidence
- Burden is on the tax-exempt organization to disprove the proposed designation
- Options for appeal are available, but once a designation has been made, significant damage to the organization will already have been done
 - U.S. banks may refuse to do business with the organization
 - Potential criminal and civil investigations may be undertaken related to other federal laws that prohibit providing material support or resources to a terrorist organization
 - Risk of further sanctions designations—i.e., Treasury's Office of Foreign Assets Control could add the organization to the Specially Designated Nationals (SDN) list, which would result in freezing all of the organization's assets, and all U.S. persons would be prohibited from engaging in any transactions with the organization

H.R. 9495, Stop Terror-Financing and Tax Penalties on American Hostages Act (cont.)

Concerns, continued:

- Three-year look-back period means that an organization's tax-exempt status could be suspended for providing material support or resources to an organization before that organization is designated as a terrorist organization

Civil Society Letter:

- A coalition of 354 organizations joined the ACLU in writing a letter to Speaker Johnson opposing H.R. 9495
- <https://www.aclu.org/documents/civil-society-letter-to-congress-opposing-hr-9495>

Considerations and Actions

Concrete Steps to Consider

- What is organization's risk profile? (legal, reputational, financial)
- What is organization's core mission?
- Is the organization a federal grant recipient or contractor?
- Analyze programs for compliance and risk management
 - Scholarships
 - Awards
 - Affinity programs
 - Advocacy and communications
- Review website, public-facing documents

Considerations and Actions

Concrete Steps to Consider

- Understand the requirements for IRS recognition of your organization's tax-exempt status and review operations for compliance
- Ensure records that may be needed for an exam are available and well organized and ensure records retention policy is being followed
- Ensure the Form 990 and all other required tax filings are complete and filed in a timely manner
- Work with experienced counsel and tax advisors; consider conducting a “mock” audit



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