

# **The Influence of a Professional Staff on Automatic Revocation of Tax-Exempt Status**

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*The US Congress passed the Pension Protection Act of 2006 (PPA) that automatically revokes the tax-exempt status of any organization that does not file with the IRS for three consecutive years. Some organizations subsequently refiled with the IRS following such revocation. This study focuses on the factors associated with refile subsequent to automatic revocation of the tax-exempt status. We find that those that refile have better reputations, are in better financial condition and are less likely to have professional employees than those that do not refile. These findings suggest that compliance with IRS filing requirements is conditioned on having professional employees.*

## **INTRODUCTION**

Exempting nonprofits from income taxes is a hallmark of public policy in the United States. Beginning in the 19<sup>th</sup> century, The United States tax code developed to exempt charitable organizations from income tax (Arnsberger et al. 2008). A caveat of this exemption is that most nonprofit organizations are required to file an annual information return Form 990 each year. As of the passage of the Pension Protection Act of 2006, failure to file an annual return (Form 990, 990-N, 990-EZ, or 990-PF) for three consecutive years leads to automatic revocation of the organization's tax exempt status (Pension Protection Act 2006).

Charities losing their tax exempt status face significant costs. The IRS lays out two main costs of losing the tax exemption (IRS 2014a). First, the nonprofit may be required to pay income tax and file a corporate or trust income tax return. Second, charities classified as 501(c)(3) organizations cannot receive tax-deductible contributions, and will not be identified by the IRS in the Business Master File as being eligible to receive tax-deductible contributions. From an individual donor's perspective, contributions made to an organization that is listed on the IRS's auto-revocation list can no longer take a charitable deduction on their individual tax return (IRS 2014b). In addition, certain states and local governments may no longer allow the organization an exemption from real property, sales, or other taxes (IRS 2014c).

The purpose of this study is to examine the factors associated with organizations reinstating their tax exempt status after automatic revocation. Organizations that fail to file and subsequently lose their tax exemption can be classified into two groups. The first group represents organizations that cease operations or merge with other nonprofits. Generally speaking, consistent with the findings in Trussel (2013), these organizations exhibit signs of financial distress in the period right before ceasing filing of

their Form 990. The second group of organizations continued their operations throughout the period of non-filing and upon realization that their tax exemption was revoked, filed their Form 990. We hypothesize that, relative to the organizations ceasing operations, these latter organizations had better reputations and were in better financial condition, but they lacked the professional staff conducive to ensuring all compliance requirements are met. An examination of these organizations is vital to our understanding of what factors attribute to noncompliance with core nonprofit IRS requirements and what improvements can be made to ensure future compliance.

We focus on the sample of organizations that the IRS reported lost their tax exemption. We compare organizations that have filed their Form 990 subsequent to revocation (“refilers”) with the group of organizations that have not refiled (“not refilers”). We find refilers are larger and have a lower level of debt relative to organizations that do not refile. In addition, we find that organizations with higher margins and professional staff are less likely to refile. Further, we find that, conditioned on the presence of professional staff, organizations in relatively better financial condition are more likely to refile. Overall, we conclude that refilers have better reputations, are in better financial condition and are less likely to have professional employees than those that do not refile. In other words, the financially sound charities with good reputations that lost their tax-exemption probably did so because they lacked the awareness or ability to file.

The findings from this study should be of particular importance to regulators as well as individuals involved with governing nonprofits. The very fact that a significant number of nonprofits fail to file their Form 990 for three consecutive years but continue operating suggests a fundamental lack of compliance with core IRS requirements. Our findings suggest governing boards should familiarize themselves with the 990 requirements and ensure the requisite forms are being properly filed. Larger organizations with relatively low debt levels without paid officers appear to be particularly vulnerable to not complying with the IRS filing requirements. Finally, our findings suggest the IRS should increase their educational outreach efforts to ensure organizations are aware of their filing responsibilities and the potential penalties they face for not filing.

The next section discusses the background and provides a literature review, while the section after next develops our model. The next to last section presents our sample and analysis, and the last section provides concluding remarks.

## **BACKGROUND AND LITERATURE REVIEW**

Organizations that meet the requirements of Internal Revenue Code (IRC) Section 501(a) are exempt from federal income taxation. The size of the tax-exempt sector is immense. According to the National Center for Charitable Statistics (NCCS), there are over 1.6 million organizations that meet the requirements of IRC Section 501(a) (“tax-exempt organizations”) and are registered with the IRS. Of those registered, 70 percent filed informational returns with the IRS in 2009, reporting total revenues of over \$1.7 trillion (NCCS 2011). Seventy-two percent of the tax-exempt organizations meet the requirements of IRC Section 501(c)(3), which include public charities (“charities”). Charities represent diverse missions that include those related to arts, education, health, human services, religion and others (Trussel 2013).

In 2006, the United States Congress passed the Pension Protection Act (PPA), which requires that most tax-exempt organizations file an annual information return or notice with the IRS. For small organizations, the law imposed a filing requirement for the first time in 2007. In addition, the law automatically revokes the tax-exempt status of any organization that does not file required returns or notices for three consecutive years. Automatic revocation occurs when an exempt organization that is required to file an annual return (for example, Form 990, 990-EZ or 990-PF) or submit an annual electronic notice (Form 990-N or “e-Postcard”) does not do so for three consecutive years (IRS 2011a, Trussel 2013).

Prior to the passage of this law, a tax-exempt organization (other than a private foundation) that normally has annual gross receipts of \$25,000 or less was not required to file. Beginning with tax years

that end on or after December 31, 2007, these smaller tax-exempt organizations must provide either an annual electronic notice (Form 990-N) or an annual information return (Form 990 or Form 990 EZ). Exceptions to the filing requirement include organizations that are included in a group return, as well as churches, their integrated auxiliaries, conventions or associations of churches, and some other religious organizations. (Private foundations of any size have always been required to file Form 990 PF).

An automatic revocation of tax exemption is effective on the original filing due date of the third annual return or notice. On June 8, 2011, the IRS published the initial list of organizations whose tax-exempt status was automatically revoked because of failure to file a required Form 990, 990-EZ, 990-PF or Form 990-N for three consecutive years (2007-2009). There were 279,599 organizations on this initial list. Of those, 176,959 (63 percent) were public charities or private foundations under IRC Section 501(c)(3), which is below the proportion in the total population of tax-exempt organizations (that is, 72 percent of the total are public charities or private foundations).

Trussel (2013) examined the financial condition of organizations that previously filed but then lost their tax-exempt status due to failure to subsequently file. He investigated whether or not financial distress contributed to the loss of tax exemption by charities that filed previous to the Pension Protection Act. Using logistic regression, he finds that charities that lost their tax-exempt status have smaller equity reserves, higher revenue concentration, lower operating margins, more debt (relative to assets) and are younger and smaller than their counterparts. His model correctly predicts up to 98 percent of the charities as either losing their tax-exempt status or not.

We build upon the Trussel (2013) model in two ways. First, we study the charities that lost their tax-exempt status but subsequently refiled with the IRS. Second, we consider factors other than just financial factors in considering reasons for refileing. In particular, we consider whether the presence of a professional staff has an impact on refileing.

## **MODEL DEVELOPMENT**

This paper addresses whether or not refileing by charities following revocation of tax-exempt status is related to certain factors, such as indicators of financial distress. Following Trussel (2013), we include factors related to reputation and financial condition. We also add factors related to professionalism, which is related to our primary research question. This section describes the indicators that we include in our model.

### **Reputation**

The ability of an organization to survive alternative business cycles is typically related to its reputation (Tinkelman 1999). Charities with good reputations will be more likely to garnish donations and other support during economic downturns. We hypothesize that charities with better reputations are more likely to refile subsequent to losing their tax-exempt status. We have two measures to proxy for reputation—the age of the organization, and the size of the organization.

*Age of the Organization (AGE)*. The age of an organization is typically related to the reputation and ability to survive alternative business cycles (Tinkelman 1999). We measure age as the difference between the sample year and the ruling date. The ruling date is the year in which the charity received its tax-exempt status. The year in which the charity began operations is not readily available.

*Size of the Organization (SIZE)*. Trussel and Greenlee (2004) find that larger charities are less vulnerable to financial distress. Factors such as economies of scale related to costs are normally correlated with size (Ohlson 1980; Tinkelman 1999). We use the natural log of total assets as a measure of *SIZE*.

### **Financial Condition**

Consistent with Trussel (2013) we control for indicators of fiscal distress. Tuckman and Chang (1991) argue that a charity is vulnerable to financial distress if it has a relatively low equity reserve, high revenue concentration, low administrative costs, or a low operating margin. Greenlee and Trussel (2000)

Hager (2001), and Trussel and Greenlee (2004) utilize similar constructs, as well. These indicators are discussed in Trussel (2013), who bases his indicators on Trussel (2002). We argue that charities less susceptible to financial distress are more likely to refile following automatic revocation. We have several measures to proxy for financial condition.

Equity Reserve (*EQUITY*). Equity, or the fund balance, can be considered a reserve available to offset a reduction of revenues. Defined as the fund balance divided by total revenues, the equity reserve can be interpreted as the number of years that the organization can operate with no additional revenues. Charities with a small reserve of equity (relative to revenues) are more likely to experience financial distress. Thus, we predict a positive relationship between the equity reserve and the likelihood of refiling.

Revenue Concentration Index (*CONCENTRATION*). Charities receive funds from several sources such as grants, donations, gifts, program services, membership dues, and investments. Charities with few sources of revenues are more likely to be vulnerable to financial distress because they cannot rely on alternatives. We compute the revenue concentration index by taking each revenue source as a percentage of total revenues, squaring this percentage and then summing these values. By construction, the index equals one if a charity earns all of its revenue from one source and approaches zero for a charity with multiple sources of revenues. We predict a negative relationship between *CONCENTRATION* and the likelihood of refiling.

Operating Margin (*MARGIN*). Operating margin is the excess of total revenues over total expenses as a percentage of total revenues. A negative operating margin means that the charity must reduce its fund balance to cover the deficit. Thus, relatively low operating margins are indicators of financial distress. We predict a positive relationship between *MARGIN* and the likelihood of refiling.

Debt Ratio (*DEBT*). An organization that relies heavily on debt to finance its operations is more susceptible to financial distress than an organization that relies less on debt. Charities will have a difficult time raising capital from banks or capital markets during periods of financial distress. We predict a negative relationship between *DEBT*, measured as the ratio of total liabilities to total assets, and the likelihood of refiling.

### **Professionalism**

The degree to which an organization complies with the myriad of tax exempt regulation is in part due to the professionalism of the staff. Prior work in the governmental field finds that entities with a chief financial officer and degreed accountants on staff are more likely to comply with generally accepted accounting principles (Carroll and Marlowe 2009, Khumawala et al. 2014). Extending this argument to the charitable sector, we expect organizations with paid officers and staff to be more likely to timely file the Form 990. Thus, we hypothesize that organizations that have paid employees prior to automatically losing their tax exemption are more likely to have failed as an organization (and not simply overlooked filing the 990) and will be less likely to refile their 990. We have two measures to proxy for professionalism—the existence of compensated officers (*OFFICERCOMP*), and the existence of a paid staff (*PAIDSTAFF*).

Many charities operate almost entirely with volunteers. We argue charities enhance the professionalism of the organization by hiring and compensating officers and other paid staff. We measure the existence of compensated officers (paid staff) with a value one if the nonprofit reports compensation paid to officers (paid to other staff), and zero, otherwise.

We hypothesize that relative to the organizations ceasing operations, refilers were in better financial condition, but lacked the administrative capacity and operating environment conducive to ensuring all compliance requirements are met. That is, we anticipate that there is an interactive effect between professionalism and financial condition.

### **Control Variable**

We also control for the sector of the charity (*SECTOR*). The various sectors differ on their susceptibility to economic cycles. We divide the sample into five major sectors, as determined by the

National Taxonomy of Exempt Entities' (NTEE). These sectors are Arts, Education, Healthcare, Human Services, and Other. All of the factors and related indicators are summarized in Table 1.

**TABLE 1  
INDICATORS OF REFILING**

| Factor              | Name          | Indicator                         | Measurement  |
|---------------------|---------------|-----------------------------------|--|
| Reputation          | AGE           | Age of organization               | 2013 – Ruling Date   |
|                     | SIZE          | Size of organization              | ln (Total Assets)  |
| Professionalism     | OFFICERCOMP   | Existence of Compensated Officers | Yes or no  |
|                     | PAIDSTAFF     | Existence of a Paid Staff         | Yes or no  |
| Financial Condition | EQUITY        | Equity Reserves                   | Total Equity/<br>Total Revenues                                |
|                     | CONCENTRATION | Concentration of Revenues         | Sum of Square of Revenue Source to Total Revenues              |
|                     | MARGIN        | Operating Margin                  | (Operating Revenues – Operating Expenses) / Operating Revenues |
|                     | DEBT          | Total Liabilities                 | Total Liabilities / Total Assets                               |
| Control             | SECTOR        | NTEE Five Major Sectors           | Arts, Education, Health, Human Services, Other                 |

## THE RESULTS OF TESTING THE MODEL

This study focuses on the indicators related to refiling following automatic revocation of tax-exempt status. Certain indicators are hypothesized to be related to charities that refile, are described in the previous section and are summarized in Table 1. This section presents the sample criteria and the empirical tests of the likelihood of refiling model.

### Sample Selection and Descriptive Statistics

The sample is derived from the October 21, 2013 IRS list of automatically revoked charitable organizations. The list contains over 540,000 nonprofits. We require organizations to be 501(c)(3) charities and have fiscal year 2006 Form 990 data available from the National Center for Charitable Statistics (NCCS) CORE file. The restrictions reduce our sample to 10,211 of which 217 are classified as refilers. Refilers have at least one Form 990 filing subsequent to the fiscal year identified by the IRS as effective year of revocation. We further restrict our sample to organizations that have all necessary financial information for analysis and are not identified as outliers. These restrictions result in a final sample of 8,645 of which 187 are classified as refilers. The sample is summarized in Panel A of Table 2.

Panel B of Table 2 partitions the sample by status (refiled or not) and sector. Overall, 2.2% of total sample refiled. All of the sectors, except the health sector, have similar instances of organizations that lost their tax exempt status and subsequently refiled. Those organizations in the health sector have fewer instances of refiling than the other four sectors.

**TABLE 2**  
**THE SAMPLE AND SAMPLE PARTITIONS**

*Panel A: The Sample*

|  | <u>Charities</u> |              |
|--|------------------|--------------|
|  | Count            | Percent      |
| Total charities receiving automatic revocation | 10,211           | 100.0%       |
| Outliers <sup>a</sup>                          | 536              | 5.2%         |
| Data not available for all variables           | <u>1,030</u>     | <u>10.1%</u> |
| Final sample                                   | 8,645            | 84.7%        |

*Panel B: The Sample Partitioned by Sector and Status*

| Sector         | Status       |                      |              | Percent Refiled |
|----------------|--------------|----------------------|--------------|-----------------|
|                | Not Refiled  | Refiled <sup>b</sup> | Total        |                 |
| ARTS           | 863          | 19                   | 882          | 2.2%            |
| EDUCATION      | 1,362        | 29                   | 1,391        | 2.1%            |
| HEALTH         | 912          | 14                   | 926          | 1.5%            |
| HUMAN SERVICES | 3,386        | 81                   | 3,467        | 2.3%            |
| OTHER          | <u>1,935</u> | <u>44</u>            | <u>1,979</u> | <u>2.2%</u>     |
| Total          | 8,458        | 187                  | 8,645        | 2.2%            |

<sup>a</sup>Outliers are defined as those charities with a continuous independent variable (except SIZE) (from Table 1) in the extreme 99<sup>th</sup> percentile.

<sup>b</sup>Refiled charities represent the number of charities in the sample that had their tax-exempt status reinstated by refiling their Form 990 with the IRS.

Panel A of Table 3 presents the descriptive statistics for the continuous variables. Using *t*-tests, we find that organizations that lost their tax exempt status and subsequently refile their Form 990 are significantly older, larger and have more equity than those that do not refile. They also have less revenue concentration and less debt.

The descriptive statistics for the categorical variables are included in Panel B of Table 3. This panel presents the number and percentage of the total organizations in the sample that display the characteristic of interest by status. Forty-three (23.0%) of the organizations that lost their tax exempt status and subsequently refile their Form 990 have paid officers, while 2,486 (29.4%) of those that do not refile have paid officers. Those that refile also have fewer with paid staff (31.6% v. 36.1%) than those that do not refile.

**TABLE 3**  
**DESCRIPTIVE STATISTICS**

*Panel A: Continuous Variables*

| Variable         | Status      | Mean    | Std. Deviation | Std. Error Mean |
|------------------|-------------|---------|----------------|-----------------|
| AGE*             | Not refiled | 12.9774 | 12.1836        | 0.1325          |
|                  | Refiled     | 14.7005 | 13.6163        | 0.9957          |
| SIZE***          | Not refiled | 10.6393 | 2.2525         | 0.0245          |
|                  | Refiled     | 11.2500 | 2.0236         | 0.1480          |
| EQUITY***        | Not refiled | 0.9908  | 2.7032         | 0.0294          |
|                  | Refiled     | 1.4164  | 2.9545         | 0.2161          |
| CONCENTRATION*** | Not refiled | 0.8088  | 0.2100         | 0.0023          |
|                  | Refiled     | 0.7654  | 0.2247         | 0.0164          |
| MARGIN           | Not refiled | 0.0867  | 0.7423         | 0.0081          |
|                  | Refiled     | 0.0268  | 0.4365         | 0.0319          |
| DEBT***          | Not refiled | 0.5330  | 1.7998         | 0.0196          |
|                  | Refiled     | 0.2197  | 0.4350         | 0.0318          |

\*  $p < 0.10$ , \*\*  $p < 0.05$ , \*\*\*  $p < 0.01$  significance using  $t$ -tests

*Panel B: Categorical Variables*

| Variable:   | Not Refiled |         | Refiled |         | Total |         |
|-------------|-------------|---------|---------|---------|-------|---------|
|             | Count       | Percent | Count   | Percent | Count | Percent |
| OFFICERCOMP | 2,486       | 29.4%   | 43      | 23.0%   | 2,589 | 29.3%   |
| PAIDSTAFF   | 3,055       | 36.1%   | 59      | 31.6%   | 3,114 | 36.0%   |

**The Initial Multivariate Model**

Since the dependent variable is categorical, refiled or not refiled, the significance of the multivariate model is addressed using logistic regression analysis. The underlying latent dependent variable is the probability of refiling for charity  $i$ , which is related to the observed variable,  $Status_i$ , through the relation:

$Status_i = 0$  if the organization did not refile,

$Status_i = 1$  if the organization refiled.

In order to replicate the Trussel (2013) model, our initial model includes only the reputation and financial condition variables from Table 1. The predicted probability of the  $k^{th}$  status for charity  $i$ ,  $P(Status_{ik})$  is calculated as:

$$P(Status_{ik}) = \frac{1}{1 + e^{-z}} \tag{1}$$

where

$$z = \beta_0 + \beta_1 Age_{it} + \beta_2 Size_{it} + \beta_3 Equity_{it} + \beta_4 Concentration_{it} + \beta_5 Margin_{it} + \beta_6 Debt_{it} + \delta_j Sector Controls_{it} + \varepsilon_i$$

Our dependent variable takes the value one if the organization is on the IRS list of revoked organizations but subsequently files a Form 990, and zero, otherwise. To test the robustness of the results, we present three variations of the initial model. Version 1 makes no standard error correction, version 2 employs robust standard errors, and version 3 clusters standard errors by sector.

Table 4 presents our determinants model for whether organizations refile their Form 990 after losing their tax exempt status. The three versions of the initial model result in similar but slightly different outcomes. Consistent with Trussel (2013) we find that organization financial characteristics are associated with refiling the Form 990. Specifically, as anticipated, larger organizations (all versions of the model), organizations with less revenue concentration (all versions), and organizations with less debt (all versions) prior to losing their tax exemption are more likely to refile their Form 990. However, in version 2 of the model, we find that, contrary to our predictions, organizations with higher margins are less likely to refile.

**TABLE 4**  
**LOGIT MODEL DETERMINING ORGANIZATIONS THAT REFILED**

|                              | Model Version Number |           |           |
|------------------------------|----------------------|-----------|-----------|
|                              | (1)                  | (2)       | (3)       |
| CONSTANT                     | -4.818***            | -4.818*** | -4.818*** |
| AGE                          | 0.003                | 0.003     | 0.003     |
| SIZE                         | 0.149***             | 0.149***  | 0.149***  |
| EQUITY                       | -0.011               | -0.011    | -0.011    |
| CONCENTRATION                | -0.621*              | -0.621*   | -0.621*   |
| MARGIN                       | -0.206               | -0.206*   | -0.206    |
| DEBT                         | -0.493**             | -0.493*** | -0.493**  |
| EDUCATION SECTOR             | -0.054               | -0.054    | -0.054    |
| HEALTH SECTOR                | -0.429               | -0.429    | -0.429*** |
| HUMAN SERVICES SECTOR        | 0.060                | 0.060     | 0.060     |
| OTHER SECTOR                 | 0.046                | 0.046     | 0.046     |
| <i>N</i>                     | 8645                 | 8645      | 8645      |
| pseudo <i>R</i> <sup>2</sup> | 0.022                | 0.022     | 0.022     |

Note: Model Version 1 no standard error correction; Version 2 robust standard errors, Version 3 standard errors clustered by sector

\*  $p < 0.10$ , \*\*  $p < 0.05$ , \*\*\*  $p < 0.01$

### The Multivariate Model with Professionalism Variables

The results on the initial model do not consider the likelihood of refiling based on the presence of professional employees. We hypothesize that relative to the organizations that do not refile, those that refile are in better financial condition and have better reputations, but lack the administrative capacity and operating environment conducive to ensuring all compliance requirements are met. The revised model includes all of the independent variables from the initial model plus the two proxies for professionalism (*OFFICERCOMP* and *PAIDSTAFF*).

The revised predicted probability of the  $k^{th}$  status for charity  $i$ ,  $P(Status_{ik})$  is calculated as:

$$P(Status_{ik}) = \frac{1}{1 + e^{-z}} \quad (2)$$

where

$$z = \beta_0 + \beta_1 Age_{it} + \beta_2 Size_{it} + \beta_3 Equity + \beta_4 Concentration_{it} + \beta_5 Margin_{it} + \beta_6 Debt_{it} + \beta_7 Officer Compensation_{it} + \beta_8 Paid Staff_{it} + \delta_j Sector Controls_{it} + \varepsilon_i$$



Table 5 presents our determinants model for whether organizations refile their Form 990 after losing their tax exempt status. The three versions of the revised model result in similar but slightly different outcomes. Consistent with Trussel (2013) we find that organization financial characteristics are associated with refiling the Form 990. Specifically, as anticipated, larger organizations (all versions of the model), organizations with less revenue concentration (version 2) and organizations with less debt (all versions) prior to losing their tax exemption are more likely to refile their Form 990. In addition to financial characteristics, we find limited evidence supporting our hypothesis that compensating officers (version 2) or other staff (version 3) is negatively associated with refiling the Form 990. However, in versions 1 and 2 of the model, we find that, contrary to our predictions, organizations with higher margins are less likely to refile. We address this issue by introducing interaction terms.

**TABLE 5**  
**LOGIT MODEL WITH PROFESSIONALISM VARIABLES**

|                       | Model Version Number |           |           |
|-----------------------|----------------------|-----------|-----------|
|                       | (1)                  | (2)       | (3)       |
| CONSTANT              | -5.258***            | -5.258*** | -5.258*** |
| AGE                   | 0.004                | 0.004     | 0.004     |
| SIZE                  | 0.200***             | 0.200***  | 0.200***  |
| EQUITY                | -0.026               | -0.026    | -0.026    |
| CONCENTRATION         | -0.569               | -0.569*   | -0.569    |
| MARGIN                | -0.249*              | -0.249**  | -0.249    |
| DEBT                  | -0.419**             | -0.419**  | -0.419**  |
| OFFICERCOMP           | -0.326               | -0.326*   | -0.326    |
| PAIDSTAFF             | -0.283               | -0.283    | -0.283*** |
| EDUCATION SECTOR      | -0.063               | -0.063    | -0.063*   |
| HEALTH SECTOR         | -0.395               | -0.395    | -0.395*** |
| HUMAN SERVICES SECTOR | 0.062                | 0.062     | 0.062     |
| OTHER SECTOR          | 0.061                | 0.061     | 0.061     |
| <i>N</i>              | 8645                 | 8645      | 8645      |
| pseudo $R^2$          | 0.026                | 0.026     | 0.026     |

Note: Model Version 1 no standard error correction; Version 2 robust standard errors, Version 3 standard errors clustered by sector

\*  $p < 0.10$ , \*\*  $p < 0.05$ , \*\*\*  $p < 0.01$

### The Revised Multivariate Model with Interaction Terms

The results on the initial or revised model do not consider the possibility that the results on financial status and reputation are conditioned on the presence of professional employees. We hypothesize that relative to the organizations that do not refile, those that refile are in better financial condition and have better reputations, but lack the administrative capacity and operating environment conducive to ensuring all compliance requirements are met. Therefore, to test whether the findings on financial status and reputation are conditioned on the presence of paid employees, we interact our officer compensation variable with size, debt and margin, and also interact our paid staff variable with size, debt and margin. We limit our interaction terms to those financial (MARGIN and DEBT) and reputational (SIZE) variables that were statistically significant in at least two versions of our full model.

The revised model includes all of the independent variables from the full model plus the interaction terms. The revised predicted probability of the  $k^{th}$  status for charity  $i$ ,  $P(Status_{ik})$  is calculated as:

$$P(Status_{ik}) = \frac{1}{1 + e^{-z}} \quad (3)$$

where

$$z = \beta_0 + \beta_1 \text{Age}_{it} + \beta_2 \text{Size}_{it} + \beta_3 \text{Equity} + \beta_4 \text{Concentration}_{it} + \beta_5 \text{Margin}_{it} + \beta_6 \text{Debt}_{it} + \beta_7 \text{Officer Compensation}_{it} + \beta_8 \text{Paid Staff}_{it} + \beta_9 \text{Officer Compensation} * \text{Size}_{it} + \beta_{10} \text{Paid Staff} * \text{Size}_{it} + \beta_{11} \text{Officer Compensation} * \text{Debt}_{it} + \beta_{12} \text{Paid Staff} * \text{Debt}_{it} + \beta_{13} \text{Paid Staff} * \text{Margin}_{it} + \beta_{14} \text{Officer Compensation} * \text{Margin}_{it} + \delta_j \text{Sector Controls}_{it} + \varepsilon_i$$

As expected, for our main effect we find a strong negative association between the presence of paid officers and likelihood of refiling. This result is consistent with organizations lacking professional staff being more likely to subsequently refile their Form 990. We further find that in the presence of professional employees, higher reputation organizations are more likely to refile. Specifically, we find that in the presence of paid officers, larger organizations are more likely to refile. Finally, we find mixed results that in the presence of professional employees, stronger financial organizations are more likely to refile. While we find that organizations with paid staff and higher margins are more likely to refile, we find organizations with paid officers and relatively more debt are more likely to refile. The above results are robust to the standard error correction. In addition, equity is significant in Version 3 along with the controls for sector.

Overall, we find that refilers have better reputations and are in a financially better position prior to losing their tax exemption but lack the professionalism of those that did not refile. The results suggest that compliance with core IRS filing requirements is conditioned on having professional employees.

**TABLE 6**  
**LOGIT MODEL WITH INTERACTIVE TERMS**

|                       | Model Version Number  |                       |                       |
|-----------------------|-----------------------|-----------------------|-----------------------|
|                       | (1)                   | (2)                   | (3)                   |
| CONSTANT              | -5.151 <sup>***</sup> | -5.151 <sup>***</sup> | -5.151 <sup>***</sup> |
| AGE                   | 0.003                 | 0.003                 | 0.003                 |
| SIZE                  | 0.191 <sup>***</sup>  | 0.191 <sup>***</sup>  | 0.191 <sup>***</sup>  |
| EQUITY                | -0.028                | -0.028                | -0.028 <sup>*</sup>   |
| CONCENTRATION         | -0.547                | -0.547                | -0.547                |
| MARGIN                | -0.319 <sup>*</sup>   | -0.319 <sup>**</sup>  | -0.319                |
| DEBT                  | -0.512 <sup>*</sup>   | -0.512 <sup>*</sup>   | -0.512 <sup>**</sup>  |
| OFFICERCOMP           | -2.892 <sup>**</sup>  | -2.892 <sup>**</sup>  | -2.892 <sup>***</sup> |
| PAIDSTAFF             | 0.887                 | 0.887                 | 0.887                 |
| OFFICERCOMP * SIZE    | 0.196 <sup>*</sup>    | 0.196 <sup>*</sup>    | 0.196 <sup>***</sup>  |
| PAIDSTAFF * SIZE      | -0.089                | -0.089                | -0.089                |
| OFFICERCOMP * DEBT    | 0.501 <sup>*</sup>    | 0.501 <sup>*</sup>    | 0.501 <sup>**</sup>   |
| PAIDSTAFF * DEBT      | -0.251                | -0.251                | -0.251 <sup>**</sup>  |
| PAIDSTAFF * MARGIN    | 0.488 <sup>*</sup>    | 0.488 <sup>**</sup>   | 0.488 <sup>**</sup>   |
| OFFICERCOMP * MARGIN  | -0.366                | -0.366                | -0.366                |
| EDUCATION SECTOR      | -0.069                | -0.069                | -0.069 <sup>*</sup>   |
| HEALTH SECTOR         | -0.422                | -0.422                | -0.422 <sup>***</sup> |
| HUMAN SERVICES SECTOR | 0.066                 | 0.066                 | 0.066                 |
| OTHER SECTOR          | 0.055                 | 0.055                 | 0.055                 |
| N                     | 8645                  | 8645                  | 8645                  |
| pseudo R <sup>2</sup> | 0.031                 | 0.031                 | 0.031                 |

Note: Model Version 1 no standard error correction; Version 2 robust standard errors, Version 3 standard errors clustered by sector

\*  $p < 0.10$ , \*\*  $p < 0.05$ , \*\*\*  $p < 0.01$

## CONCLUSION

We study the factors associated with tax-exempt organizations that refiled their Form 990 after having their tax-exempt statuses automatically revoked by the IRS. Trussel (2013) finds that charities that lost their tax-exempt status exhibited signs of financial distress in the period right before ceasing filing of their Form 990. Many of those did not file their Form 990 in the subsequent years. However, a much smaller group of organizations continued their operations throughout the period of non-filing and upon realization that their tax exemption was revoked, filed their Form 990. We hypothesize that relative to the organizations ceasing operations, these latter organizations were in better financial condition and had better reputations but lacked the administrative capacity and operating environment conducive to ensuring all compliance requirements are met.

We find organizations that lose their tax exempt status and subsequently refile their Form 990 are larger, more likely to be in good financial health, and less likely to have paid employees relative to organizations that do not refile. Our analysis helps to tease out organizations that lose their tax exemption for administrative reasons (e.g. not having an informed and sufficiently professional staff) from the alternative fiscal distress reasons (e.g. going bankrupt, merging, etc.). This study also highlights the importance of sufficient capacity for nonprofits. Prior research has documented the importance of capacity in growing nonprofits (Chikoto and Neely, 2014). Our study also highlights the importance of capacity in complying with the key regulations faced by nonprofits. Organizations without financial means or professional staff are more likely to fail to comply with fundamental nonprofit reporting requirements. While increasing capacity is the surest way to ensure compliance, organizations with limited capacity should consider alternatives such as recruiting professional board members, or forming advisory committees focused on the regulatory aspects of running nonprofits. In addition, regulators should consider the fact that a significant number of nonprofits lack the professional staff to keep abreast of the myriad of regulatory requirements currently facing nonprofits. Educational outreach efforts to inform nonprofit boards and directors should yield increasing compliance and help nonprofits avoid the adverse consequences of failing to comply with tax exempt regulation.

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