

Board Training Kits: Nonprofit Association Tax Compliance

#7



Southern Early Childhood Association

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Nonprofit Associations and Taxation

Even though nonprofit associations may show greater income than expenses at the end of their fiscal year, they are allowed to retain their nonprofit status. The determination of an organization's nonprofit status under law focuses primarily on the reasons for which it is organized and operated rather than on its year-to-year financial situation. A determination by the Internal Revenue Service (IRS) of an organization's tax-exempt status generally permits the organization to accumulate income without the burden of federal income taxes. However, even though an association is tax-exempt, it may occasionally have to pay taxes. This may happen under three conditions:

1. The association may be subject to federal income taxes when it generates income from activities not related to the purpose for which tax exemption was originally granted. This is called unrelated business income tax (UBIT).
2. An exempt association may also be required, depending on the tax laws of the jurisdiction where it is located or organized, to pay local taxes on real estate or personal property, sales taxes on goods or services, and certain other miscellaneous taxes.
3. The association has paid employees, for whom it must pay employment taxes, just like any other entity.

Source: Jerald Jacobs. Association Law Handbook. Third Edition. Washington, DC: American Society of Association Executives, 1996.

Reasons for Organizations to Seek Tax-exempt Status

Some of the primary reasons organizations may seek to attain (or retain) tax-exempt status include:

- Tax-exempt status enables the organization to receive dues and certain other income without paying taxes on that income.
- Tax-exempt status generally allows the organization to accumulate income tax-free.
- Tax-exempt status with the IRS may in some instances meet state or local requirements for exemption from property, sales, and other taxes.
- Tax-exempt status entitles the organization to a threshold deduction with regard to unrelated business income, which is not available to non-exempt organizations.
- Tax-exempt status may allow or encourage public officials or others to work with the organization in a manner that they would not be able to do if the association were considered a for-profit organization.

- Some types of tax-exempt status allow associations to receive tax-deductible charitable contributions.
- Tax-exempt status may allow an organization to qualify for nonprofit postal permits, which provide significantly reduced postal rates.

Sources: Jerald Jacobs. *Association Law Handbook*. Third Edition. Washington, DC: American Society of Association Executives, 1996. p. 378.

Jeffrey Tenenbaum. *Association Tax Compliance Guide*. Washington, DC: American Society of Association Executives, 2000, pp. 5-6.

Why Are Nonprofit Organizations Tax-Exempt?

Why do federal, state and local governments grant tax-exempt status to certain organizations?

- Nonprofits relieve the government's burden. Private schools and hospitals, day care centers, homeless shelters, and other nonprofits provide services that the government might otherwise be required to offer. Through tax-exemption, the government supports the work of nonprofits and receives a direct benefit in return.
- Nonprofits benefit society. Nonprofits encourage civic involvement, provide information on public policy issues, encourage economic development, and do other activities that make society richer and more vibrant. Even though the government only benefits from these services indirectly, the public benefits overall.
- Taxing nonprofits would be difficult and counter-productive. If the government were to tax nonprofits, it would have difficulty determining what qualified as taxable income. The government would also have to consider the adverse effects taxation might have on the viability of many worthwhile organizations

As nonprofit organizations have grown in both size and scope, the distinction between nonprofits and for-profits has become less clear. Recently, many state and local governments have launched challenges to the tax-exempt status of nonprofits, and a number of states have attempted to establish narrow criteria for tax-exemption so that far fewer nonprofits would qualify. These initiatives, in turn, have challenged nonprofits to do a better job of explaining their partnership with government, why they deserve exemption, and how they benefit society.

Source: www.BoardSource.org 2006.

IRS Classification: The 501(c)(3) Organization

The criteria for the 501(c)(3) classification are somewhat overlapping, and neither the IRS nor the courts have consistently emphasized all of them.

1. The organization must be organized and operated primarily for purposes that are beneficial to the public interest, including: relief of the poor, distressed, or underprivileged; advancement of religion; advancement of education and science; building or maintenance of public buildings or monuments; lessening the burden of government; elimination of prejudice and discrimination; defense of human and civil rights; combating community deterioration and juvenile delinquency. Unrelated activities will not disqualify the organization from 501(c)(3) status so long as they do not constitute a substantial part of the organization's overall activities.
2. The organization must not be organized for profit. This standard can usually be met by incorporation under state nonprofit corporation law with clear language in the association's governing documents (Articles of Incorporation, bylaws) that it is not organized for profit. These governing documents should be carefully drafted to ensure compliance with this organizational test.
3. The organization must have a written plan for its own dissolution that supports the purposes stated in its Articles of Incorporation. Upon dissolution, the organization's assets must be distributed to another 501(c)(3) charity.
4. The organization must protect itself against, and prevent, private benefit from its operations. No part of the organization's net earnings can be intended for the benefit of any private shareholder or individual.
5. The organization's activities must not be confined to the performance of particular services for individual members. Each association service must be viewed by itself to see if it could be considered a particular service for individual members and detrimental to tax-exempt status. However, specific incidental services to members (i.e., advice to a member from association staff) will not be considered a violation of the statute.
6. No substantial part of the organization's activities may constitute carrying on propaganda or otherwise attempting to influence legislation. Qualifying associations place limits on lobbying, though some associations may elect, in lieu of the uncertain substantial test with respect to lobbying activities, to be governed by a limitation defined in terms of dollar expenditures. This procedure enables these organizations to engage in lobbying activities with a reasonable degree of certainty concerning future tax-exempt status.

7. The organization must not participate in any political campaign on behalf of any candidate for public office. Political activities related to campaigns must be avoided, including position statements written in support of specific candidates or political parties.

See “Publication 557: Tax-Exempt Status for Your Organization” at www.irs.gov for more information regarding the specific rules and regulations of declaring a nonprofit organization to be eligible for 501(c)(3) status.

Sources: Jerald Jacobs. *Association Law Handbook*. Third Edition. Washington, DC: American Society of Association Executives, 1996. pp. 370-377.

Jeffrey Tenenbaum. *Association Tax Compliance Guide*. Washington, DC: American Society of Association Executives, 2000, pp. 7-11.

Tax-Exempt Associations and the Internal Revenue Service: A Timeline

During its existence, any tax-exempt organization will have numerous interactions with the IRS. The following, with information excerpted from the www.irs.gov website, indicates the steps of an organization’s “life cycle.”

Phase I: Starting Out

- Articles, Trust or Charter: To qualify for exemption under IRS section 501(c)(3), an organization must be organized exclusively for purposes described in that section. This means, among other things, that the organization’s articles of organization must contain certain provisions limiting the organization’s purposes to one or more of the exempt purposes set forth in section 501(c)(3). The articles must not expressly empower it to engage, other than as an insubstantial part of its activities, in activities that are not in furtherance of one or more of those purposes. An organization seeking tax-exempt status must ensure that the charitable purposes for which it exists comply with those in the IRS code, and make any necessary changes to its Articles of Incorporation to ensure compliance.
- Bylaws: Federal tax law does not require specific language in the bylaws of most organizations. However, exempt organizations must maintain their financial reports and file returns based on an annual accounting period called a tax year, and organizations that want to specify an annual accounting period generally do so in their bylaws. A tax year is usually 12 consecutive months. There are two kinds of tax years:
 - The calendar tax year is a period of 12 consecutive months beginning January 1 and ending December 31;
 - The fiscal tax year is a period of 12 consecutive months ending on the last day of any month except December.

- **Employer Identification Number (EIN):** Every organization must have an employer identification number, even if it will not have employees. The employer identification number is a unique number that identifies the organization to the Internal Revenue Service. To apply for an employer identification number, you should obtain IRS Form SS-4.
- **Registration for Charitable Solicitation:** Many states have laws regulating the solicitation of funds for charitable purposes. These statutes generally require organizations to register with a state agency before soliciting the state's residents for contributions, providing exemptions from registration for certain categories of organizations. In addition, organizations may be required to file periodic financial reports. State laws may impose additional requirements on fundraising activity involving paid solicitors and fundraising counsel.

Phase II: Applying to the IRS

The best source for information regarding filing for nonprofit tax-exempt status is the Internal Revenue Service itself. For specific process details, visit the IRS website at www.IRS.gov. Choose Charities & Non-Profits from the table of contents, and you will be able to find the particular regulations relating to different tax-exempt categories and information on what you need to apply for your tax-exempt status. You can also access all the various forms and publications and there is a helpful “Frequently Asked Questions” section answering additional questions.

- **Application Criteria:** To be exempt under section 501(c)(3), an organization must file an application for recognition of exemption with the IRS. The law provides limited exceptions to the filing requirement. An organization that is not a private foundation and the gross receipts of which in each taxable year are normally not more than \$5,000 is excepted from the exemption application requirement.
- **IRS Form 1023:** Associations seeking exemption under Section 501(c)(3) use IRS Form 1023 to request the determination. Form 1023 has instructions and checklists to help you provide the information required to process your application. The form is filed with the IRS Key District Office having jurisdiction over the state in which the association will have its main office.
- **IRS Form 8718:** When you send your application Form 1023 to the IRS, you also need to submit Form 8718, User Fee for Exempt Organization Determination Letter Request, and include a payment that varies depending on historical and anticipated annual gross receipts. The budget calculations attached to your application will help you estimate your future revenue and therefore your fee.

- IRS Processing: Your exemption application may provide enough information for the IRS to issue a ruling on your exempt status under section 501(c)(3). Frequently, however, the IRS reviewer will need additional information to complete your application. The reviewer will write a letter requesting the additional information by a specified date.
- IRS Determination Letter: This is the most important legal document your organization possesses. The IRS sends you this letter after you have successfully applied for the recognition of your organization's tax-exempt status. In this document the IRS indicates under which section of the Internal Revenue Code your organization is qualified. In order not to have your status revoked, your organization must continue operating according to the manner you described in your application. The determination letter is the only official document and proof that your organization is recognized as a tax-exempt organization.

Phase III: Annual Filings

There are both initial and continuing IRS procedural requirements for associations to follow in seeking to obtain and working to maintain federal income tax exempt status.

- IRS Form 990, Return of Organization Exempt from Income Tax: Form 990 is a tax form that nonprofits file with the IRS annually. This public document provides information that allows the IRS to determine whether the organization continues to fulfill the requirements for its tax-exempt status. Form 990 explains the mission and program activities of the organization, and details revenues, expenses, and net assets. Organizations are also required to list the names of the board members and key staff and their compensation (if more than \$50,000 annually).
 - The Form 990-EZ, Short Form Return of Organization Exempt from Income Tax, is designed for use by small tax-exempt organizations. An organization may file Form 990-EZ, instead of Form 990, only if its gross receipts during the year were less than \$100,000, and its total assets at the end of year were less than \$250,000.
 - Form 990 or Form 990-EZ must be filed by the 15th day of the 5th month after the end of your organization's accounting period. A tax-exempt organization that fails to file a required return is subject to a penalty of \$20 per day. The same penalty will apply if the organization fails to give correct and complete information or required information on its return.
- Unrelated Business Income Tax (UBIT): See above section on UBIT for more information. An exempt organization that has \$1,000 or more of gross income from an unrelated business must file Form 990-T. An organization must pay estimated tax if it expects its tax for the year to be \$500 or more.

- Employment Taxes: Every employer, including a tax-exempt organization, who pays wages to employees is responsible for withholding, depositing, paying and reporting federal income tax, social security taxes (FICA), and federal unemployment tax (FUTA) for such wage payments.
- Independent Contractors: If an association employs independent contractors to whom they pay at least \$600 during the year for services, they must file Form 1096, Annual Summary and Transmittal of U.S. Information Return, annually.

Phase IV: Ongoing Compliance

Important Employment Tax Forms:

- IRS Forms W-4, Employee's Withholding Allowance Certificate, and I-9, Employment Eligibility Verification: The organization must file IRS Forms W-4 and I-9 for each association employee.
- IRS Form W-2: The organization must furnish a copy of Form W-2, Wage and Tax Statement, to each employee who received wages to during the year.
- IRS Form W-3: The organization must file Form W-3, Transmittal of Wage and Tax Statements, to transmit Copy A of Forms W-2 to the Social Security Administration by the last day of February after the calendar year for which the Forms W-2 are prepared.
- IRS Form 945: The organization must file Form 945, Annual Return of Withheld Federal Income Tax, to report income tax withheld from non-payroll payments, such as pensions, IRAs, and backup withholding.

Reporting Charitable Contributions:

Contributions to charitable causes are not taxed because they improve the general public good and do not benefit the taxpayer personally. Gifts that are given to a qualified nonprofit organization, for which the donor receives nothing in return, are considered tax-deductible. If the donor receives something in return for the donation, the difference between the amount of the donation and the value of the item received in return is deductible. All charitable 501(c)(3) organizations can receive tax-deductible donations.

The Internal Revenue Code applies substantiation requirements for donors, and disclosure requirements for charitable organizations, in connection with charitable contributions. A donor can deduct a charitable contribution of \$250 or more only if the donor has a written acknowledgment from the charitable organization. The donor is responsible for requesting and obtaining the written acknowledgement from the organization accepting the contribution.

Public Disclosure:

In general, IRS regulations require tax-exempt organizations to provide copies of certain tax documents to requesting individuals. These tax documents are usually to be provided immediately in the case of in-person requests and within 30 days in the case of written requests. The tax-exempt organization may charge a reasonable copying fee plus actual postage, if any. These disclosure requirements are in addition to the requirement that tax-exempt organizations must make their tax-documents available for public inspection.

Phase V: Significant Organizational Changes

- Organizational Changes that Could Jeopardize Compliance: A section 501(c)(3) organization will jeopardize its exemption if ceases to be operated exclusively for exempt purposes. A 501(c)(3) organization: must absolutely refrain from participating in the political campaigns of candidates for local, state, or federal office; must restrict its lobbying activities to an insubstantial part of its total activities; must ensure that its earnings do not inure to the benefit of any private shareholder or individual; must not operate for the benefit of private interests such as those of its founder, the founder's family, its shareholders or persons controlled by such interests; must not operate for the primary purpose of conducting a trade or business that is not related to its exempt purpose; and may not have purposes or activities that are illegal or violate fundamental public policy.
- Material Changes: An organization must notify the IRS of material changes in its form, activities, or sources of support. This includes notifying the IRS of any merger with another organization and when the organization terminates. An organization may also seek a private letter ruling on the tax consequences of changes that it intends to make in its structure or activities.

Sources: www.irs.gov/charities and www.BoardSource.org 2006.

Independent Contractors

Before a tax-exempt organization can determine how to treat payments for services rendered, it must first know the business relationship that exists between the organization and the person performing the services. The person performing the services may be an independent contractor, a common-law employee, a statutory employee, or a statutory non-employee. In determining whether the person providing the service is a common law employee or an independent contractor, all information that provides evidence of the degree of control and independence must be considered.

It is critical that the organization, as the employer, correctly determine whether individuals providing services are employees or independent contractors. Generally, the organization must withhold income taxes, withhold and pay Social Security and Medicare taxes, and pay unemployment tax on wages paid to an employee. The organization does not generally have to withhold or pay any taxes on payments to independent contractors.

If the employee is considered to be an independent contractor, separate forms must be filed with the IRS:

- IRS Form 1096, Annual Summary and Transmittal of U.S. Information Returns: The organization should file Form 1096 to transmit Copy A of Forms 1099, 1098, 5498, and W-2G to the IRS. The tax-exempt organization must file Form 1096 with each type of return annually.
- IRS Form 1099-MISC, Miscellaneous Income: A tax-exempt organization is not required to withhold income tax or social security and Medicare taxes from, or pay social security and Medicare taxes or federal unemployment tax on, amounts it pays to an independent contractor. Generally, if the organization pays at least \$600 during the year to a non-employee for services (including parts and materials) performed in the course of the organization's business, it must furnish a Form 1099-MISC, Miscellaneous Income to that person by January 31st of the following year.
- IRS Form W-9, Request for Taxpayer Identification Number and Certification: The organization should always ask the independent contractor to complete IRS Form W-9 before beginning work.

Deductibility of Meeting Expenses for Attendees

Expenses incurred by association members or others in attending professional association conventions, seminars, and other meetings generally are tax deductible as ordinary and necessary business expenses if the attendance is primarily for business or professional reasons rather than for pleasure or personal reasons.

Items that typically are deductible under these circumstances include meeting registration fees, travel to and from the meetings, transportation at the meetings, lodging, and other incidental expenses. If an individual's firm pays for the expenses of attending the association meeting, the expenses ordinarily would be deductible on the firm's tax return. If an individual pays for the expenses and is not reimbursed by the firm, the expenses may be deductible on the individual's tax return.

Problems for attendees may arise in the area of tax deductibility of expenses incurred in attending association meetings where individuals combine trips to the meetings with pleasure trips, where individuals bring their spouses to the meetings, or where the meetings are held in locations outside North America.

It is important to remember that the expenses of attending an association meeting are deductible only if the primary purpose for attending is to derive a business or professional benefit, according to IRS regulations. In order to make this determination, the government will look at the amount of time devoted to business or professional activities at the meeting when compared to the amount of time devoted to recreational or social activities.

Guidelines for Ensuring Meeting Attendance will be Tax-Deductible

It is possible to glean some arbitrary guidelines from court decisions regarding IRS code on the tax deductibility of meeting expenses for maximizing the likelihood of tax-deductible treatment for expenses of participants. It is important to note that these are only guidelines, and no recommendations are universal or unequivocal.

- The program of any meeting should be planned to reflect the business or professional interests of attendees.
- Announcements, brochures, agendas, printed programs, and all other documentation of a meeting's subject matter should emphasize its business and professional aspects and de-emphasize any incidental social or pleasure aspects.
- The major portion of a program should be business-related or profession-related.
- Promotion of an association convention, seminar or other meeting as tax deductible runs certain risks because the association cannot control all factors used to determine for a specific individual if expenses for attending are indeed deductible. Most associations avoid making representations to attendees regarding their own tax deductibility of meeting expenses.

Source: Jerald Jacobs. Association Law Handbook. Third Edition. Washington, DC: American Society of Association Executives, 1996. pp. 431-434.

Questions For Discussion

1. What aspects of your organization's purpose or mission qualify it for 501(c)(3) status under IRS Code?
2. For what reasons did your organization seek tax-exempt status in the past? If your organization is not currently tax-exempt, why would you seek that status now?
3. How well does your organization conform to the seven criteria for 501(c)(3) tax-exempt status listed in this presentation? What could be done to ensure that your association does not violate these criteria in the future?
4. Do your organization's Articles of Incorporation and bylaws conform with the 501(c)(3) standards for stating organizational purpose? Does your association have an Employer Identification Number? Does your state require your association to file paperwork in order to solicit charitable contributions within its borders?
5. Based on the process described in "Phase II: Applying to the IRS," is there anything that your association should have done differently in its application for tax-exempt status? Was anything omitted that should have been handled? Do you have proper documentation for each and every step?
6. Does your association maintain a schedule and checklist for its annual filings with the IRS? Who is in charge of managing the filing process, and what type of oversight is employed by your association to ensure compliance with IRS regulations?
7. Who manages the tax process as it relates to association employees? Are all required forms filed in a timely manner with the IRS and clearly documented in association files? Do any improvements in this process need to be made?
8. Does your organization employ independent contractors? Who is responsible for managing these contractors? Is all required IRS documentation kept current and on file with the association?
9. What types of measures are taken by your organization to meet IRS requirements so that those people who attend your meetings have the potential to deduct their meeting expenses? What changes could be made to ensure your association's compliance with the standards by which meeting expenses may be deducted?

Sources

www.BoardSource.org

www.irs.gov/eo

IRS Publication 15: Circular E, Employer's Tax Guide

IRS Publication 15-A: Employer's Supplemental Tax Guide

IRS Publication 505: Tax Withholding and Estimated Tax

IRS Publication 557: Tax-Exempt Status for Your Organization

IRS Form 940: Employer's Annual Federal Unemployment (FUTA) Tax Return

IRS Form 941: Employer's Quarterly Federal Tax Return

Publication 1771: Charitable Contributions: Substantiation and Disclosure Requirements

IRS Publication 4220: Applying for 501(c)(3) Tax-Exempt Status

IRS Publication 4221: Compliance Guide for 501(c)(3) Tax-Exempt Organizations

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