Chapter 15

Not-for-Profit Organizations—
Regulatory, Taxation, and
Performance Issues
Learning Objectives

After studying Chapter 15, you should be able to:

- Identify oversight bodies and the source of their authority over not-for-profit organizations (NPOs)

- Describe how and why states regulate NPOs, and describe:
  - Not-for-profit incorporation laws
  - Registration, licenses, and tax-exemption
  - Lobbying and political influence
Learning Objectives (Cont’d)

Identify how the federal government regulates NPOs, and describe:

- Tax-exempt status—public charities and private foundations
- Unrelated business income tax
- Restricting political activity
- Intermediate sanctions
- Reorganization and dissolution
Learning Objectives (Cont’d)

Describe governance issues of NPO Boards, including:
- Incorporating documents
- Board membership

Identify how benchmarks and performance measures can be used to evaluate NPOs
Why Should Accountants Understand Nonprofit Law?

Accountants must be familiar with regulations and laws facing not-for-profit, tax-exempt organizations because

- Auditors must express an opinion on whether the organization complied with laws and regulations
- Accountants may be asked to assist in the preparation of specialized reports
Creation of an NPO

- Individuals who share a desire to work together towards a purpose other than to earn a profit for owners will form an NPO

- Generally, the two steps involved are to:
  - Incorporate with a state to establish a legal existence separate from the founders
  - Apply to the IRS for exemption from federal income taxes
State governments have oversight over NPOs because states grant legal existence through not-for-profit incorporation laws, charitable trust laws, or limited liability companies.

The federal government has oversight over NPOs because the federal government grants exemption from federal income taxation (i.e., tax-exempt status).
Starting out (registering as a not-for-profit corporation, charitable trust, LLC)

Annual compliance reporting

Licenses (e.g., for charitable solicitation or to operate a facility)

Limit on political activity

Tax compliance (e.g., sales and use tax)

Notice of plans to dissolve
Federal Government Oversight of NPOs

An NPO will interact with the Federal government throughout its life cycle (see Ill. 15-2):

- Starting out
- Applying to the IRS for tax-exemption
- Required annual filings
- Ongoing compliance
- Significant events
Life Cycle: Starting Out

- An NPO will get a taxpayer or employer identification number (TIN or EIN)

- Articles of incorporation and by-laws that were filed with the state must be available when applying for federal tax-exempt status
Life Cycle: Applying for Tax-exempt Status

- NPOs will apply on Form 1023 or Form 1024 to be exempt from federal income taxes.

- They identify under which subsection of Internal Revenue Code 501 they expect to be exempt (see Ill. 15-3).

- NPOs are assumed to be a public charity (rather than a private foundation) for the first five years.
NPOs will file an annual information return, either Form 990-N, Form 990-EZ, or Form 990.

NPOs that have more than $1,000 of gross income from an unrelated business will file a Form 990-T and be taxed at corporate tax rates.
Life Cycle: Ongoing Compliance

- NPOs interact with the IRS during the year to:
  - Pay employment taxes if they hire employees
  - Provide substantiation and disclosures for non-cash contributions

- NPOs are subject to:
  - Public disclosure rules related to the Form 990
  - Intermediate sanctions when individuals have excessive private benefits from transactions with the NPO
  - Loss of exempt status if they engage in an improper type and amount of political activity

- Private foundations are subject to excise taxes for certain prohibited behavior
Life Cycle: Significant Events

- An NPO needs to notify the IRS if it plans to merge or terminate the organization (dissolve)

- Private letter rulings may be requested for unique transactions in which the NPO is engaged

- The IRS may audit the NPO and conclude there are problems that must be addressed
Which Organizations Must File a Form 990 with the IRS?

- NPOs that are tax-exempt under IRC Sec. 501. The revised Form 990 for 2008 requires a postcard filing (990-N) for small NPOs and a 990-EZ or 990 for others depending on size, and according to a phase-in schedule.
- Private foundations file a Form 990-PF.
- Note that churches and federal agencies are not required to file Form 990s.
A revised Form 990 for tax years 2008 and after is comprised of an 11-page core form and 16 different schedules (prepared as needed)

Revisions include a summary front page with signature of the NPO officer and more questions related to governance and performance

The IRS expects the changes will enhance transparency, allow it to more efficiently assess noncompliance, and minimize the filing burden on NPOs
Information on a Form 990

- Financial information includes:
  - Balance sheet, statement of activities
  - Details of revenue sources and functional expenses
  - Compensation to key employees and others
  - Lobbying expenses

- Nonfinancial information includes:
  - Largest contributions with donors’ names
  - Statement of program services accomplishments
Public Charity or Private Foundation?

- To be a **public charity** an NPO must meet two parts of a broad public support test (each year) and conduct programs

- If an NPO fails the broad public support test, it will be determined to be a **private foundation**

- When an NPO first applies for tax-exemption, it will be presumed to be a public charity and will have to meet the public support test at the end of the fifth year
Public Charities – Public Support Test

wild An external support test is met if > 1/3 of total revenue comes from the government, general public (including private foundations), or other public charities in the form of

- Contributions, grants, membership dues, charges for services, sales of merchandise

wild An internal support test is met if < 1/3 of total revenue is from investment income and unrelated business income
Private Foundations

- Receive support from a small set of donors, earn investment income, and make grants to other NPOs that operate programs

- Private foundations face excise taxes for:
  - Failure to take certain actions (e.g., distribute a minimum amount to public charities)
  - Prohibited behavior (e.g., speculative investing and self-dealing transactions)
  - Net investment income (which is then used to support the costs of auditing tax-exempt organizations)
Unrelated Business Income Tax (UBIT)

- An NPO that earns income from activities that are not substantially related to its charitable or tax-exempt mission must pay tax
  - On the *unrelated business net income*
  - That exceeds $1,000
  - At corporate tax rates
Activities That are **Not** Subject to UBIT:

- Investment income
- Royalties and fees for use of intangible property (including sale of mailing lists according to recent court cases)
- Gains on sale of property
- Work done by volunteers
- Legally conducted games of chance
- Rents from real property
- Activities that primarily benefit members
Examples of Activities That Could be Unrelated

- Sponsorships
- Advertising
- Affinity credit card arrangements
- Travel services
- Fund-raising events
General rule is that no substantial part of an NPO’s activities may constitute

- Carrying on *propaganda* (i.e., information skewed toward a particular belief with little factual basis), or

- Attempts to influence *legislation* (i.e., action by Congress, a state legislative body, or a local council to establish laws and ordinances)
Other Limits on Political Activity

- Participation in political campaigns on behalf of a candidate will result in loss of exempt status
- Excessive political expenditures (other than a permissible amount of *direct lobbying* or *grass-roots lobbying* subject to a ceiling) are taxed
- Political expenditures can never exceed $1 million in a year
Intermediate Sanctions

Penalties on NPOs that confer *excess economic benefits in transactions* with persons who have substantial influence over the organization (e.g., directors and managers)

*Intermediate sanctions* are these penalties:
- Repay the excess benefit
- Pay a tax of 25% of the excess benefit
- Pay another 10% tax if the managers were aware the transaction was improper
- Pay 200% more of the excess benefit if the transaction is not corrected within the period
Examples of Excessive Economic Benefits

- Unreasonably high compensation (compared to similar employees at similar organizations)
- Sales of assets at bargain prices
- Lease arrangements at other than fair market value
An NPO May Reorganize Because

- Those societal needs for which it was created are met or are a lesser priority
- Mergers with other NPOs will result in efficiencies or additional funding resources
If an NPO Dissolves, It Must

- Pay all creditors
- Pay all federal, state, and local taxes
- File proper forms with the state
- Transfer all assets held in trust for the benefit of society to other public charities or a government
Accounting Issues with Reorganizations

- **Due diligence** — formally disclosing all relevant information, particularly about risks

- Filing proper forms with the state and Federal government
Governance Issues: Incorporating Documents

- Articles of incorporation (external focus) describe the purpose of the organization and exempt purpose for which it was established.

- By-laws (internal focus) describe the functional rules of the organization.

- Minutes of the Board meetings (legal history of the organization).
Governance Issues: Responsibilities of Board Members

- Set policy
- Provide fiscal and ongoing guidance
- Monitor continuous quality improvement
- Fund-raising
Board Treasurers

- Have custody of corporate funds and securities
- Keep full and accurate records of all receipts and disbursements
- Deposit money and valuables in designated depositories
- Authorize disbursements
Several groups monitor and evaluate NPOs and compare their performance measures to benchmarks, and/or provide resources for NPOs and donors. For example,

- BBB Wise Giving Alliance [www.give.org](http://www.give.org)
- American Institute of Philanthropy [www.charitywatch.org](http://www.charitywatch.org)
- Independent Sector [www.independentsector.org](http://www.independentsector.org)
- Urban Institute [www.nccs.urban.org](http://www.nccs.urban.org)
- Guidestar [www.guidestar.org](http://www.guidestar.org) (makes Form 990s easily accessible on the Internet)
The National Taxonomy of Exempt Entities (NTEE) was created by the National Center for Charitable Statistics (with a coalition of invested parties).

The taxonomy classifies exempt entities into one of 26 categories, such as, arts and culture, health care, housing and shelter, community and capacity building (with a further breakdown).

This taxonomy can be used in compiling benchmarks for related groups of exempt entities.
Financial Performance Measures
(See Ill. 15-6)

- Liquidity measures (Can the organization pay its current bills?)
- Going concern measures (Are revenues sufficient to cover expenses?)
- Capital structure (Does the organization rely more on debt or equity to finance its operations?)
- Program effectiveness (Is an appropriate amount spent on accomplishing the NPO’s goals?)
Financial Performance Measures, Cont’d (See Ill. 15-6)

- Efficiency (Is the cost per achieved output decreasing over time?)
- Leverage and debt coverage (Is the debt service expense adequately covered by revenue?)
- Fund-raising efficiency (Are contributions received appropriately higher than the cost of raising those funds?)
- Investment performance (Is the rate of total return on investments reasonable?)
Program outcomes and assessment measures are quite important in evaluating an NPO, in addition to financial performance measures.

- **Outputs** – How many people were served or units of service were provided?
- **Outcomes** – Was the mission accomplished (e.g., are children healthier or can they read at a higher grade level)?
Many states have adopted uniform policies for NPOs created by the American Bar Association or National Association of Attorneys General. Some are:

- The Uniform Prudent Management of Investment Funds Act (UPMIFA) of 2006
- Model Nonprofit Corporation Act
- Model Charitable Solicitation Act
Concluding Comments

- Accountants report on whether NPOs complied with laws and regulations

- NPOs first receive legal status from a state and then apply to the IRS for exemption from federal corporate income taxes; hence are accountable to both governments throughout their life cycle

- The ability to benchmark and compare NPO performance is increasing with the availability and revision of the Form 990

END