Non-Profit Accounting 101

Imagine you have this great idea to start a company. You come up with this amazing product or service idea that is going to make the world a better place. You run this idea by a friend that is in a professional service industry, such as, let's say healthcare. They too think it is a great idea that can help a ton of people and generate a lot of revenue. Your friend suggests setting up this company as a non-profit to avoid paying taxes on the revenue that your company/idea may generate. On the surface this sounds like a great idea. Nobody wants to pay taxes. Especially on an idea that, if executed properly, can generate a significant amount of money. Before you go down the path of setting up a non-profit organization, you may want to brush up on the rules for non-profits and how your "idea" may not actually meet those guidelines.

The Legal Information Institute of Cornell Law School defines a non-profit organization as one that is "organized for purposes other than generating a profit and in which no part of that organization's income is distributed to its members, directors or officers. For federal tax purposes, an organization is exempt from taxation if it is organized and operated exclusively for religious, charitable, scientific, public safety, literary, educational, prevention of cruelty to children or animals, and/or to develop national or international sports". Some examples of non-profit organizations include churches, public service organizations such as Rotary or Kiwanis, the Chamber of Commerce, educational entities such as the Inland Northwest SIDS Foundation and of course, the National Football League. Yes, the NFL, an organization that generates over $9 Billion in annual revenue is a non-profit organization.

A non-profit organization is often referred to as a 501c3. This numbering sequence references the Internal Revenue Code of 1986, Title 26, Section 501. There are 29 different types of non-profit organizations that are exempt from paying some federal income taxes. These cover everything from Federal Credit Unions (c1) to Health Insurance Issuers (c29). The infamous, (c3), covers the items we referenced in the Cornell Law School example previously. One thing to remember about a (c3) organization, a donor's contribution may be tax-deductible only if it is used for the specific use of the organization and the organization is not serving as an agent or conduit of a foreign charitable organization. 501c3 organizations also cannot conduct political campaigning. If you are looking to setup a political non-profit, you would want to look at a (c4) or an (h) designation. Otherwise, the organization is at risk of losing its tax-exempt status.

Non-Profit organizations are often identified as "tax-exempt" organizations. While in part this may be true for many non-profits, it may not be true for others. How do you know if your organization is exempt or not? First, your State will determine if your organization is exempt from sales tax. Each State has their own rules when it comes to identifying which non-profit organizations are exempt from tax. Even if the organization is approved under the State tax rules, there may be additional rules related to purchases, purchaser and method of payment made/received. Some State's require that all conditions are met, while some require one or some are met. Most States (approximately 30 of them) simply require that a non-profit organization submit their IRS Determination Letter, Articles of Incorporation/Bylaws, and Financial Statements

(Form 990) in order to receive tax-exempt status. The one thing to keep in mind is that each State is different in their requirements. It is always best to know what those requirements are prior to conducting business in that State.

Many non-profit organizations operate as a Board of Directors that have no employees. In those cases, the Board often does not take any form of reimbursement. Rather, they volunteer their time and energy in service to the non-profit. Some non-profits have an Executive Director (ED) and no employees. That organization may operate solely on volunteers outside of the ED and the Board. In this case, the ED is considered an employee. In other cases, the organization may have an Executive Director and employees. If the organization does have employees, the organization is still responsible for Federal, State and Local taxes. These employment taxes may include Federal Income Tax Withholding (FITW), Social Security and Medicare (FICA) or Federal Unemployment Taxes (FUTA).

Even though a non-profit organization may not pay income taxes, it is still a requirement that most non-profit file an annual income tax return. The organization must file form 990 with the IRS each year. The organizations information becomes public record, which can be viewed by the general public to evaluate the organizations operations. This information may include the mission, programs and financials of the organization. Faith-based organizations, subsidiaries of non-profit organizations and government corporations are exempt from filing an annual tax return. In most cases, a non-profits tax return is due by May 15th each year. Should a non-profit organization fail to file for three consecutive years their tax-exempt status will automatically be revoked. Once revoked, there is no appeal process and the organization is then subject to paying income tax.

Non-profit organizations that run into problems tend to have some common themes. Just like any other business, the non-profit must keep accurate and up to date financial records. Because non-profits tend to operate predominately with a Board of Directors, one member may be assigned the task of treasurer. This person may, or may not, have a financial background of some sort. Just because someone has a financial background, does not make them a good bookkeeper or accountant. In order to protect Board members, and the organization, it is often best to hire an outside professional bookkeeper or accountant to maintain the financial records of the organization. Board makeup is another area that can be a red-flag. A majority of Board members should not be related, whether by blood, marriage or common business interest. Board members should also not be paid as employees of the organization. Critical tasks may also not be getting completed correctly, such as donor receipts or payroll tax filing. Non-profits are held to the same standards as any other company or business when it comes to their management. The IRS may choose to levy "intermediate sanctions" against the Board members personally for organizations not meeting compliance or standards .

While the name non-profit may imply the organization has very little financial means, the opposite is quite often the truth. Many non-profit organizations are sitting on a plush pile of cash. That pile of cash, however, needs to be dedicated to the purpose to promote their cause or advance their programs. Non-profits generate revenue in a number of ways. They may apply for and obtain a grant through a government agency or private foundation. They may receive corporate support from a business. They may sell a product or service. For example, the Girls Scouts sell a selection of very addictive cookies each year. The funds from these cookie sales fund their programs. The non-profit may hold tournaments or fundraisers. Finally, the organization may also receive public and private support in the form of donations.

The big myth is that non-profit organizations can be used for a tax dodge. As you can see, the IRS has set specific guidelines for what constitutes a non-profit organization. There are rules to how a Board of Directors is setup and how employees are paid. The organization must have a specific purpose that meets one of the 29 different types of non-profit organizations identified by the IRS. There are financial reporting and record keeping requirements that must be followed.

If you are thinking of starting a non-profit organization, I would strongly encourage you to meet with an attorney that specializes in non-profit work, and an accountant that understands Title 26, Section 501 of the Internal Revenue Code. If you already operate a non-profit organization, I would encourage you to review your organization against this White Paper to ensure you are in compliance with the codes discussed. Due diligence and review will help ensure your organization stays off the front page of the paper, and that donations continue to be received to support your organizations purpose.