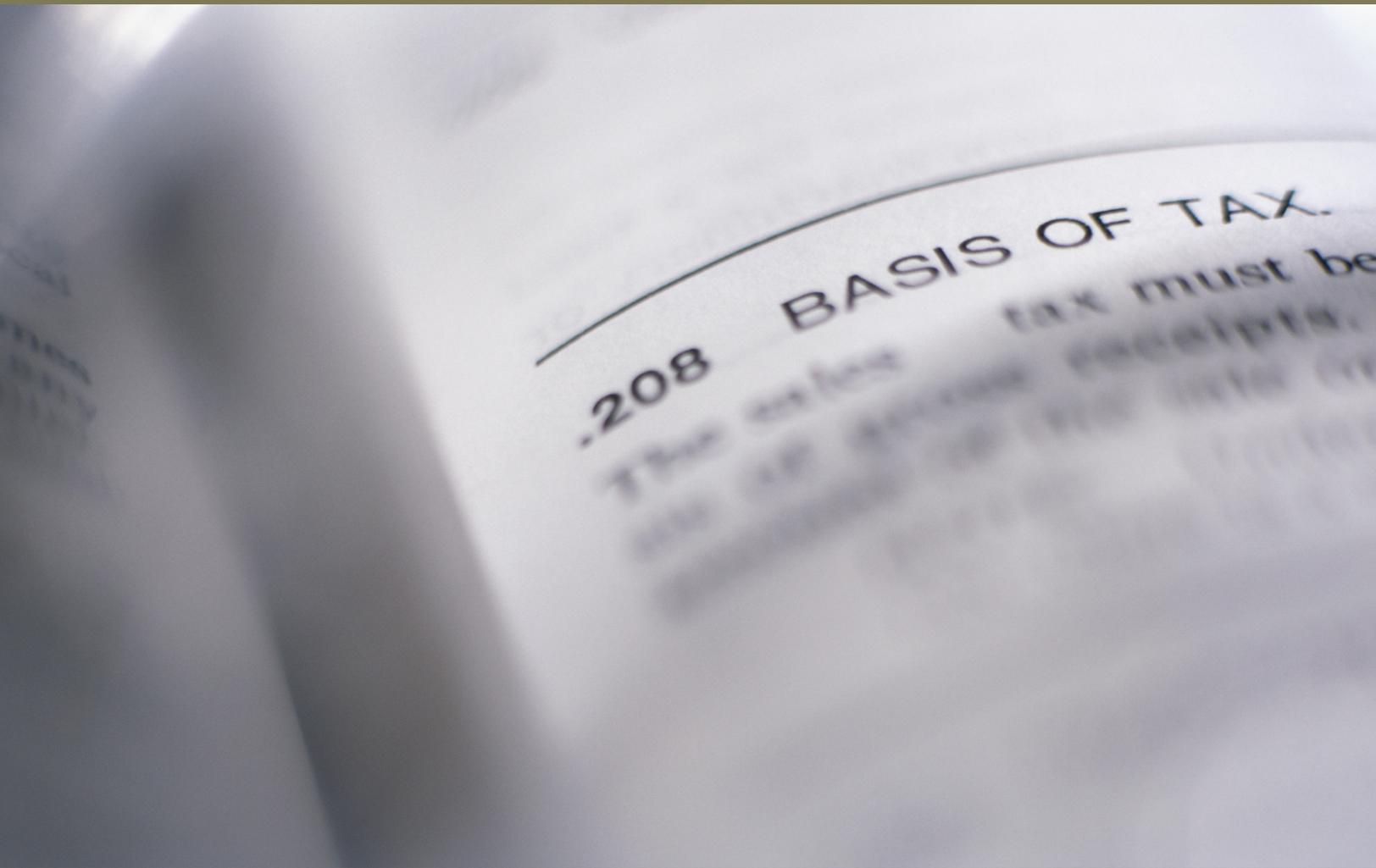


Income Tax Issues Affecting Small Nonprofit Organizations



Virginia Society of
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Introduction

Income tax laws and regulations are often confusing and sometimes even frightening. Indeed, tackling the U.S. Internal Revenue Code (IRC) may seem to be a task not for the faint of heart. This guide is intended to present some basic information to volunteer treasurers, directors and board members of nonprofit organizations (NPO) to help them obtain, maintain and understand exemption from income taxation and possibly relieve some of the confusion and fear.

As is the case with most tax law, there are exceptions to every rule. The information presented in this guide is general, and will not be applicable to every specific situation encountered by an NPO. Furthermore, because of the intricacies of the IRC, it would be impossible for this guide to address all aspects related to the taxation of NPOs.

Should any of the topics covered in the following pages raise questions as to how the law pertains to your specific organization, we urge you to consult with your Certified Public Accountant (CPA). The Virginia Society of CPAs (VSCPA) sponsors a volunteer program and maintains a pool of highly trained tax and financial experts throughout the state who have offered their time and expertise to NPOs in need of help. Visit www.financialfitness.org for more information on the VSCPA programs and resources available to assist NPOs.

This guide uses an example NPO called "Goodworks, Inc." — a hypothetical entity organized in Virginia for the purpose of soliciting contributions from the general public and using the funds to help address a specific societal need. We will discuss how Goodworks would obtain exemption from taxation, the various IRC sections that would affect Goodworks' exemption, filing of the necessary returns with the U.S. Internal Revenue Service (IRS) and other tax-related topics.

State Registration and Virginia Solicitation of Contributions Law

In general, every corporation that is incorporated under Virginia law, has registered with the State Corporation Commission for the privilege of conducting business in Virginia or that receives income from Virginia sources must file a Virginia corporation income tax return. Non-profit organizations are not required to file a Virginia corporation income tax return unless they incurred unrelated business taxable income at the federal level. (See the Unrelated Business Taxable Income section of this guide for further explanation.)

However, most charitable organizations operating in the Commonwealth of Virginia, like Goodworks, are required to file an initial registration form with the Commissioner under sections 57-48 through 57-69 of the Code of Virginia, as amended Feb. 23, 2007. Filing the statements and subsequent annual statements as required under this chapter is generally the duty of the secretary, president, chairman or other principal officer of the charitable organization. Charitable solicitation forms and regulations can be downloaded from the Virginia Department of Agricultural and Consumer Services (VDACS) website at <http://tinyurl.com/28s98fw>.

In fact, most states require nonprofits that solicit contributions in their state to be registered in that state. If Goodworks makes any kind of solicitation, including mailings and phone calls, to another state, then Goodworks is required to be registered in that state also. Large, national organizations are often required to register in all 40-plus states that require registration. Failure to register in a particular state can, in the most extreme case, result in the organization being barred from solicitation in the state and having to return contributions to contributors. Usually, first-time penalties are not so severe, but this is not an area to ignore. Even if the penalty is minor, it does not generate great publicity for a charitable organization.

Internal Revenue Code Section 501(c)

Most types of charitable organizations that qualify for exemption from income taxes are enumerated in Section 501(c) of the IRC. Visit the IRS website at www.irs.gov for detailed tax information concerning nonprofit organizations. There are 23 subsections under Section 501(c) that deal with a wide array of potential NPOs. As our example company, Goodworks, intends to operate as a charitable organization, its activities would fall under Section 501(c)(3). Other types of NPOs would be classified under other subsections. For instance, civic leagues would be exempt under 501(c)(4), while social and recreational clubs would meet the criteria of 501(c)(7).

Obtaining Tax Exemption

Exemption from income taxes is not automatic. Regardless of an organization's charitable or benevolent intent, tax exemption must be granted by the IRS. Generally, one of two forms must be filed by an aspiring NPO to obtain an exemption from the IRS. An organization like Goodworks that feels its activities would qualify for exemption under Section 501(c)(3) would file Form 1023 with the IRS. Most other NPOs that would fall under other subsections of 501(c) should file Form 1024. A user fee must be included with the application for tax-exempt status; in most circumstances, the fee is \$850 for NPOs that expect to exceed \$10,000 in revenue, or \$400 for smaller NPOs.

An NPO seeking tax exemption must include acceptable documentation in its filing. The NPO must have an acceptable legal form. Reasonable financial projections for the NPO's next three to four years are required with the application. It is important to note that, in general, in order for a NPO to be recognized as exempt by the IRS from its inception, it must apply for exemption within 27 months of the end of the month in which it is organized.

Once an NPO received a tax-exempt determination from the IRS, it must file the appropriate Forms 990, 990-EZ, or 990-N each year to retain its tax-exempt status.

Public Charity vs. Private Foundation

All organizations exempt under Section 501(c)(3) are, by definition, either public charities or private foundations. The IRS states that a 501(c)(3) NPO automatically will be considered a private foundation unless it is one of the following types of organizations:

- Church, convention of churches or association of churches
- School
- Hospital or cooperative hospital service organization
- Federal, state or local government or governmental unit
- Medical research organization in conjunction with a hospital
- NPO operated for the benefit of a college or university
- NPO that receives a substantial part of its support from a governmental unit or from the general public
- NPO that receives more than one-third of its support from membership fees and gross receipts from activities related to its charitable functions, and less than one-third from investment income
- NPO whose primary purpose is to support another NPO described above

Classification as a private foundation has certain disadvantages. These NPOs are subject to a 1- to 2-percent income tax on their net investment income (interest, dividends, etc.). Moreover, private foundations also are required to distribute 5 percent of their assets each year for exempt purposes, and if these distributions are not made, a second tax of 15 percent is imposed on undistributed amounts. Goodworks should not be classified as a private foundation by the IRS, as it will receive most of its support from the general public in the form of contributions. It is important to remember that regular large grants and gifts from one source could change the status of the nonprofit.

Filing Form 990

In general, all NPOs (except religious organizations) are required to file an annual information return with the IRS. Most NPOs (including Goodworks) must file Forms 990 or 990-EZ by the 15th day of the fifth month after their fiscal year ends (e.g., May 15 for a year ending Dec. 31). An NPO can choose any reasonable 12-month period for its fiscal year, such as July 1 to June 30 for a school or school affiliate. Private foundations and certain other non-exempt charitable trusts must file Form 990-PF.

Those with gross receipts of less than \$50,000 are required to electronically submit Form 990-N, also known as the e-Postcard. Gross receipts include all income from all sources during the tax year without subtracting

any expenses.

Some organizations may still choose to complete the Form 990 in order to provide the transparency that large donors demand. It may be necessary to reassess what 990 form is required based on the organization's specific financial position and disclosure requirements. In general, a change may be needed when your gross receipts reach one of the thresholds. When this happens, the IRS generally looks at a 3-year period previous to reaching the threshold.

Form 990 essentially requires the NPO to report to the IRS its income statement and balance sheet in a prescribed format, and extensive questions concerning the operations of the NPO must be answered. Substantial penalties may be assessed for failure to file Form 990 or the required annual statement in a timely manner, while revocation can occur after three years for non-filing. Ignorance of the requirements is not considered by the IRS to be a reasonable cause for noncompliance.

As part of the Form 990, all NPOs must report the compensation they pay to individuals and firms. Part VII of Form 990, Schedule A requires the NPO to report to the IRS information concerning the compensation for its officers, directors, key employees, and highest-compensated employees. Part VII of Form 990, Schedule B requires similar compensation data for independent contractors earning more than \$100,000. Part VI of Form 990, Schedule B asks for information concerning any joint ventures the NPO may have had with any other taxable entity or organization not exempt under 501(c)(3).

Any changes in an NPO's organizational documents (bylaws, articles of incorporation, etc.) must be reported to the IRS by attaching a copy of the changes to the Form 990 filed in the year of the changes.

Forms 990, 990EZ and 990PF are considered public information, except for the schedule of contributors. Copies of the forms are available to the general public from the IRS or from the exempt organization. The NPO must make available to the public its recent 990 forms and its application for exemption, as specified in the IRS instructions. As part of its efforts to promote transparency, GuideStar also posts Form 990 for many charities at www.guidestar.org, except for the NPO's schedule of contributors.

Recent changes to Form 990 by the IRS stress adherence to the organization's exempt purpose and internal

controls established by directors and management to assure adherence to the exempt purpose. Failure to adhere to the exempt purpose or to control the actions of the organization may result in loss of exempt status. A well-run NPO that maximizes the percentage of its contributions that goes toward "programs" (i.e., its missions) rather than "management" and "fundraising" (i.e., its overhead), plus has in place all the internal controls that the IRS monitors, has in its annual Form 990 a strong marketing tool to convince potential donors that the NPO is a charity worth supporting.

Unrelated Business Taxable Income

If it is recognized as an NPO by the IRS, Goodworks may receive an unlimited amount of income that is "substantially related to the pursuit of its exempt purpose" and, in general, would not be subject to income taxes. However, an NPO that regularly engages in non-exempt business activities, such as a gift shop, is subject to tax on the net income from these activities. If this unrelated business taxable income (UBTI) becomes "substantial" (a term not defined by the IRS), the NPO could even lose its exempt status.

In order for income from an activity to be considered UBTI, each of the following criteria must be met:

- The activity producing the income must be a "trade or business," which means any activity carried on for the production of income from the sale of goods or the performance of services.
- The activity must be "regularly carried on," which is defined as an activity that shows frequency and continuity and is pursued in a manner similar to commercial activities conducted by comparable for-profit entities.
- The activity must not be substantially related to the NPO's exempt purpose. Just because an activity raises needed funds for the NPO does not mean, in the eyes of the IRS, that the activity is related to its exempt function. The activity itself must bear a direct relation to the NPO's exempt purpose.

Several types of income are specifically excluded by the IRS from classification as UBTI. Types of income that are excluded from taxation for NPOs exempt under Section 501(c)(3) include:

- Income generated substantially by unpaid volunteers
- Income from the sale of merchandise donated to the NPO
- Dividend, interest and royalty income and gains

from the sale of property

- Rental income from real property (unless the property is debt-financed)

Some of these types of income may be taxable for NPOs exempt under other subsections of 501(c). For example, interest and dividend income is taxable for organizations exempt under Section 501(c)(7).

Some examples of income that could be taxed as UBTI include:

- Operation of a mailing service for other NPOs
- Most advertising in exempt organization periodicals
- Publication of a magazine for distribution to the public
- Sale of membership mailing lists on a commercial basis

Examples of income types that may be excluded from taxation include:

- Tournaments held by an organization formed to promote such events
- Operation of a cafeteria, coffee shop, gift shop and parking lots by a hospital
- Sale by a museum and its gift shop of greeting cards reproducing works of art

An NPO's first \$1,000 of net UBTI is exempt from taxation. Any amounts in excess of \$1,000 are taxed at the same rates as for-profit corporations. NPOs receiving more than \$1,000 in gross UBTI in any year are required to file Form 990T. UBTI is a topic of the tax law with many gray areas, and this discussion covers only the basics. UBTI recently has become a "hot item" with the IRS, and sources of UBTI will be a major focus of their audits. Accordingly, if an NPO has a potential UBTI problem, it should consult a CPA.

Penalties

The IRS has a variety of penalties available to enforce compliance with its filing and taxation regulations. This

publication cannot detail these penalties, but the NPO should be aware that they exist. The cost of these punitive provisions can be significant to the small NPO. The most common penalties are outlined in the instructions to the Form 990 and address such areas as failure to file on a timely basis, failure to allow public inspection, failure to file Form 990T if the organization has UBTI and inadequate prepayment of estimated income taxes. If an NPO suspects that it may be subject to these or other penalties, it should seek advice from a CPA.

Other Provisions

In order to claim a tax deduction for contributions of cash, checks or other monetary gifts, the donor must have a bank record or a written communication from the NPO showing the name of the NPO, the date of the contribution and the amount of the contribution. A taxpayer making a non-cash contribution must have a receipt from the NPO. A contribution in excess of \$250 requires a written acknowledgement from the NPO. In addition, net charitable deductions are available only if made directly to a tax-exempt organization and the donor receives no value in return (e.g., dinner and entertainment at a special event). The organization must be able to present a tax-exempt approval letter from the IRS unless it is a church.

Conclusion

The material presented herein is designed to provide basic information concerning income tax issues affecting small nonprofit organizations. If an organization feels it needs assistance with obtaining exemption, filing Form 990 or determining whether it has a problem with UBTI, it should seek the help of a CPA.

The VSCPA offers free resources including a Nonprofit Pro Bono Assistance program and the Find a CPA directory to help connect nonprofit organizations with a CPA in their geographic location who can best meet their financial and business needs. For more information, visit the VSCPA's Nonprofit Resource Center at <http://www.vscpa.com/NPOResources>.

This guide was last updated in September 2012 by CPAs serving on the VSCPA Nonprofit Resource Guides Task Force. CPAs and nonprofit organizations are freely encouraged to email or copy this guide to share with officers and directors serving on nonprofit boards. For permission to duplicate this guide or modify it for any other purpose, please contact the Virginia Society of CPAs at 4309 Cox Road, Glen Allen, VA 23060, (804) 270-5344 or vscpa@vscpa.com.



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