

Nonprofits, the IRS, and Recordkeeping Fundamentals

Getting the fundamentals right is essential for any nonprofit. This course introduces how the IRS classifies and oversees nonprofit organizations, what compliance looks like from the start, and how proper recordkeeping and accounting practices support long-term tax-exempt status. Whether you're new to the nonprofit sector or looking to reinforce your foundational knowledge, this course gives you a clear framework for understanding the relationship between nonprofits and federal tax requirements.

CREDIT HOURS 2 | FIELD OF STUDY TAXES | EXAM QUESTIONS 10

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LEARNING ASSIGNMENTS AND OBJECTIVES

Assignment

- Study the full course materials included here.
- Complete the review questions after each chapter.
- Answer 10 final exam questions.
- Final exam is scored immediately, 70% or better passes.
- Certificate of completion is available in your account.
- Failed exams can be retaken free of charge.

Course Objectives

- Recognize the varying tax considerations of tax-exempt organizations.
- Identify which accounting methods comply with GAAP.

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INTRODUCTION

This course is for you if you have a nonprofit that's up and running, whether it's been one day or one decade. You have dealt with the IRS already because you have your tax-exempt status. Now you're wondering what else the IRS has in store for you and your nonprofit? The answer is: A lot.

Your nonprofit's relationship with the IRS doesn't end when you receive your tax-exempt status. Indeed, that's only the beginning. The IRS will continue to oversee your compliance with the myriad of complex tax laws and regulations governing nonprofits. Dealing with the IRS and its rules is the price all nonprofits pay in return for the substantial tax benefits they receive.

Failure to comply with nonprofit tax laws can lead to dire consequences—revocation of your tax-exempt status, or the imposition of taxes and penalties on your nonprofit, or even on your officers, directors, or employees personally.

Fortunately, most nonprofits can handle IRS compliance tasks themselves or with minimal help. This course can help. It contains step-by-step guidance on:

- How to file annual information returns with the IRS
- What types of records your nonprofit is required to keep
- Classifying workers as employees or independent contractors and dealing with employment taxes
- How to comply with the tax laws governing the use of volunteers
- The deductibility of charitable contributions
- When you must provide written substantiation for contributions
- Avoiding IRS taxes or penalties due to conflicts of interest, payment of excessive compensation, insider transactions, and other prohibited behavior
- How to avoid having to pay taxes on side businesses your nonprofit conducts to earn extra income
- What types of lobbying are and aren't allowed, and
- How to steer clear of the prohibition on political activity.

Running a nonprofit is difficult enough these days without having to worry about the IRS looking over your shoulder. Turn to this book whenever you have a question about IRS rules or nonprofit compliance issues.

Tip

What this course is not. This course isn't about how to form a nonprofit corporation or apply for IRS recognition of your nonprofit's tax-exempt status. It has been written primarily for Section 501(c)(3) organizations that qualify as public charities, and it doesn't cover the special tax rules applicable to private foundations. Moreover, while much of the material here is applicable to nonprofits other than Section 501(c)(3) organizations, this course hasn't been written with such organizations in mind.

Chapter 1: NONPROFITS AND THE IRS

Chapter Objective

After completing this chapter, you should be able to:

- Recognize the varying tax considerations of tax-exempt organizations.

This chapter provides an overview of what it means to be a nonprofit and the role the IRS plays in regulating these organizations. Nonprofits and the IRS are inextricably intertwined: You create or run a nonprofit and you will have to deal with the IRS. How much will depend on what type of nonprofit you have and its size and activities. But nonprofits of any size need to be aware of the basic rules that govern their existence and operations. This chapter gives a brief overview of those rules and the IRS's role in the life of a nonprofit—from formation, to annual disclosures, to ongoing compliance, to audits, to winding up.

WHAT DO WE MEAN WHEN WE SAY “NONPROFIT”?

What do the following organizations have in common: the United Way, the Metropolitan Museum of Art, Harvard University, the Internet Archive, Talmudic Research Institute, the Mothers' Club of Grosse Pointe South High School, Alcoholics Anonymous, Gates Foundation, Mayo Clinic, and YMCA? You guessed it: They're all nonprofit organizations. Many terms are used—sometimes interchangeably—to describe these organizations: “nonprofit,” “charity,” “charitable organization,” “public charity,” “private foundation,” “501(c)(3) organization,” and “tax exempt.” What they all share is that they exist for a purpose other than earning money for their owners.

Any organization or business that exists to earn a profit for its owners is a “for-profit” organization. Microsoft, Inc., which Bill Gates cofounded, is a perfect example of a for-profit entity. It exists to enrich its owners—the shareholders. In contrast, a nonprofit has no owners and its purpose is not to enrich the people who run it. For example, the purpose of the Gates Foundation is not to earn money for Bill Gates. Rather, it is to use its money to “increase opportunity and equity for those most in need.” Nonprofit organizations can and do earn money. But they must use it for their stated nonprofit purposes, not for the private gain of any individual. Indeed, they are legally barred from distributing any profits they earn to the people who control them, such as directors, officers, or members.

Not all nonprofits are tax exempt. However, this is a small subset of nonprofits and not one that we deal with in this course. For the most part, the IRS and tax issues covered in this course wouldn't be relevant to this group of nonprofits.

Tax-Exempt Nonprofits

The most common and well-known tax-exempt nonprofits are Section 501(c)(3) organizations. These are nonprofits formed for charitable, educational, scientific, or religious purposes. When people use the term “nonprofit,” they are usually referring to 501(c)(3) nonprofits. However, there are 27 other types of tax-exempt nonprofits. The most common of these are social welfare organizations. These are organizations operated exclusively to promote social welfare, such as volunteer fire companies, homeowners’ associations, and advocacy organizations like the League of Women Voters. Other types of non-501(c)(3) nonprofits are membership organizations (social and recreational clubs), business leagues (chambers of commerce), fraternal organizations (college fraternities), cooperative organizations, and credit unions. A complete list of all 28 categories of tax-exempt nonprofits can be found at the end of IRS Publication 557, *Tax-Exempt Status for Your Organization*. This publication can be downloaded from the IRS website at www.irs.gov.

What all these nonprofits have in common is that they don’t pay federal income tax on income they earn that is related to their nonprofit purposes. Tax-exempt nonprofits are also exempt from federal unemployment taxes and, depending on their state law, from most state and local taxes, such as state corporate income tax, sales tax, and property taxes. In some cases, the exemption from state and local taxes may equal or exceed the financial benefit derived from the federal exemption. Other than this tax exemption that they all share, the 28 different types of nonprofits are subject to different tax rules and benefits depending on what type of nonprofit they are.

Section 501(c)(3) Charitable Organizations

By far the most common tax-exempt organization, and the type this course deals with, is the Section 501(c)(3) charitable organization. These organizations aren’t limited to what we normally think of as charities, such as homeless shelters or hospitals. Rather, they include any nonprofit organized and operated exclusively for one or more of the following tax-exempt purposes:

- Charitable
- Educational
- Religious
- Scientific
- Literary
- Testing for public safety
- Fostering national or international amateur sports competition, and
- Preventing cruelty to children or animals.

These nonprofits are referred to as “Section 501(c)(3) organizations” because they are governed by Section 501(c)(3) of the tax code. In addition to tax-exempt status, donations to Section 501(c)(3)

organizations are tax deductible for the donors. This provides an enormous incentive for donors that almost no other type of nonprofit is afforded by the tax law. In return for this special tax treatment, Section 501(c)(3) organizations are subject to more tax rules and regulations than other nonprofits.

Charitable, Educational, and Religious Nonprofits

“Charitable,” “educational,” or “religious” nonprofits can be created for many different purposes. These terms are meant to be broadly construed and they encompass a broad range of activities.

Charitable. Charitable organizations conduct activities that promote:

- Relief of the poor, the distressed, or the underprivileged
- Advancement of religion
- Advancement of education or science
- Construction or maintenance of public buildings, monuments, or works
- Lessening the burdens of government
- Lessening neighborhood tensions
- Eliminating prejudice and discrimination
- Defending human and civil rights secured by law, and
- Combating community deterioration and juvenile delinquency.

Educational. Educational nonprofits are involved in the “instruction or training of the individual for the purpose of improving or developing his capabilities” and “the instruction of the public on subjects useful to the individual and beneficial to the community.” Such organizations include, but aren’t limited to:

- Schools, such as a primary or secondary school, college, university, professional, or trade school
- Organizations that conduct public discussion groups, forums, panels, lectures, or similar programs
- Museums, zoos, planetariums, symphony orchestras, theater groups, or similar organizations
- Nonprofit daycare centers, and
- Youth sports organizations.

Religious. Religious nonprofits include all types of churches. “Churches” include synagogues, temples, mosques, and similar organizations. Other religious nonprofits include those that don’t carry out the functions of a church, such as mission organizations, speakers’ organizations, nondenominational ministries, ecumenical organizations, or faith-based social agencies.

Private Foundations and Public Charities

The IRS classifies every Section 501(c)(3) organization as either a private foundation or a public charity. This classification is important because private foundations are subject to strict operating rules and regulations that don't apply to public charities. For example, deductibility of contributions to a private foundation is more limited than for a public charity, and private foundations are subject to excise taxes that aren't imposed on public charities. The bottom line is that private foundations get much worse tax treatment than public charities. So, you don't want your nonprofit to be a private foundation if you can avoid it.

The main difference between private foundations and public charities is where they get their financial support. A private foundation is typically controlled by an individual, a family, or a corporation, and obtains most of its income from a few donors and investments—a good example is the Gates Foundation. Because they are controlled by such a small group, private foundations can easily be misused and abused. This is why the tax law is so tough on them. Most foundations just give money to other nonprofits. However, some—called “operating foundations”—operate their own programs. As a practical matter, you need at least \$1 million to start a private foundation. Otherwise, it's not worth the trouble and expense. It's not surprising, then, that a private foundation has been described as a large body of money surrounded by people who want some of it.

Most Section 501(c)(3) organizations are public charities. They have a much broader base of financial support than private foundations and have more interaction with the public. Certain organizations, such as churches, schools, hospitals, and medical research organizations, automatically qualify as public charities. Others must prove that they are publicly supported, which generally means they must be able to show they receive at least one-third of their support from contributions, membership fees, or gross receipts from activities related to their exempt functions.

This course is primarily concerned with public charities, not private foundations. From here on, whenever we refer to “nonprofit,” we are referring to public charities.

Most Nonprofits Are Section 501(c)(3) Charitable Organizations

According to the *IRS Data Book*, in 2023, 1,999,457 organizations were exempt from tax. Of these, 1,514,558 were Section 501(c)(3) charitable organizations. The next largest groups were social welfare organizations, 73,467; business leagues, 58,764; social clubs, 47,327; labor, agricultural, and horticultural organizations, 44,478; fraternal beneficiary societies, 37,755; and veterans organizations, 26,913.

THE LIFE CYCLE OF A NONPROFIT

The existence of a nonprofit for tax purposes can be divided into stages: