

## Chapter 1

# Defining and Scrutinizing the Nonprofit Sector

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### *In This Chapter*

- ▶ Discovering what nonprofits have in common
  - ▶ Looking at nonprofits and small businesses side by side
  - ▶ Understanding the recent legal changes regarding nonprofit governance
  - ▶ Concentrating on governing positively and effectively
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**T**he United States nonprofit sector workforce consists of about 11 million people, or 7 percent of the entire U.S. workforce. Numbers like these make the U.S. nonprofit sector the sixth largest economy in the world — larger even than the economies of Canada or Russia.

To give you a closer look at this booming workforce, this chapter reviews some of the core characteristics of U.S. nonprofits: why so many exist and the policy reasons that justify granting millions of them tax-immunity.

But there's even more to this opening chapter. Those people who are running nonprofits also need to be aware of recent scrutiny and legislation in the nonprofit world. Inspired by tales of fundraising fraud, conflicts of interest, bloated compensation, and careless accounting, state and federal legislators are hard at work creating new laws to restore public confidence. After cracking down on corporate America by enacting the Sarbanes-Oxley Act (which lays down the restrictions, limitations, and requirements for the for-profit sector), lawmakers and enforcement officials are beginning to target the country's 1.8 million nonprofits for legislation. This chapter discusses the ramifications of this attention.

## The vastness of the nonprofit sector

The nonprofit sector is pervasive nearly every aspect of American culture. Virtually every U.S. citizen has some type of regular interaction or relationship with a nonprofit entity. Here are a few statistics to help you appreciate the enormity of the nonprofit sector:

- ✓ **Charities make up about half of it:** Of the approximately 1.8 million nonprofits in the United States, more than half of them (about 780,000) are charitable. The other half fulfill other missions (such as promoting arts, culture, business cooperation, social interactions or public and community goals).
- ✓ **It's multiplying like gerbils:** The number of nonprofits in this country has tripled since 1963. It's estimated that 20,000 to 30,000 new nonprofits are started each year.
- ✓ **It has financial strength in numbers:** The vast majority of nonprofits are small, just like the majority of U.S. for-profit businesses are. For example, most nonprofits have an annual gross revenue of less than \$25,000 a year. However, the cumulative revenues of these organizations are \$710 billion, or about 9 percent of the U.S. gross domestic product (which is the total value of all goods and services produced and sold by the United States).

## Characteristics That Nonprofits Share

A nonprofit organization is an organization with a purpose. The purpose, known as its *mission*, is an overriding goal other than making a profit. For example, a nonprofit may promote cancer research, improve access to goods services for low-income individuals or foster arts such as opera and ballet. All nonprofits have a reason for their existence.

For profit entities (such as corporations and other businesses ultimately answer to shareholders, owners, and partners. Unlike their for-profit counterparts, nonprofits do not exist to generate revenue for owners or shareholders. Nonprofits do not even have owners and shareholders. Rather, all nonprofits have *stakeholders*.

## Stakeholders



A stakeholder, as the term implies, is an individual or group with an interest in having the nonprofit fulfill its mission. Stakeholders include anyone who's interested or affected by the nonprofit organization and its services. Stakeholders in the nonprofit sector include the following:

- ✓ **Users:** By users, I mean the people and parties who actually use the services and goods created, distributed, or allocated by the nonprofit organization.
- ✓ **Donors and funding sources:** This group includes the people and entities (including the government) that help fund the operations of the nonprofit.
- ✓ **Community:** Often the surrounding community as a whole will have a stake in how well a nonprofit organization meets its mission and objectives.

## Documentation

Each nonprofit has its own DNA-like uniqueness. However, three particular types of documentation link most nonprofits: mission statements, charters, and bylaws.

### *Mission statements*

A *mission statement* isn't a legal document, but it's the document that defines a nonprofit organization's goals and reasons for existing. All nonprofits should have a clear mission statement that's reviewed periodically to make sure that it reflects the organization's current objectives. Not only does a mission statement help keep the nonprofit on track, it also informs the public of what that organization's objectives are. (See Chapter 4 for more on mission statements, including information on creating and drafting your organization's statement.) Nonprofits generally fulfill their missions by creating and managing an organizational structure that's staffed and organized to meet their day-to-day goals.



When an organization has outlived its mission (or in other words, if the issues for which it was formed no longer exist), the nonprofit itself may cease to exist. Or, if the nonprofit isn't fulfilling its mission, it may be rightfully questioned by its stakeholders.

### *Charters*

A *charter* is the prerequisite for official status as a nonprofit corporation within a state. In other words, it's the constitution of the organization. This document, which is sometimes also called a *certificate of incorporation*, is typically filed with the secretary of state. Changes to the charter require a formal amendment.



Most states require organizations to file annual reports to keep their non-profit status.

### ***Bylaws***

For nonprofit corporations, *bylaws* outline the basic operating rules for your organization and spell out how it's governed. Bylaws include rules pertaining to directors, officers, meetings, and voting. (Flip to Chapter 4 for more on this document.)

## ***Funding and financing***

Most nonprofits don't generally conduct their own operations to generate income. In fact, as Chapter 5 explains, nonprofits are not allowed to compete with the private sector businesses. Rather, nonprofits typically depend on the following sources to finance activities consistent with their missions:

- ✓ **Donations:** Private citizens can sometimes get tax deductions when they donate money to nonprofits. (The specifics of tax-deductibility of donations are covered in Chapter 14.)
- ✓ **Fundraising activities:** Nonprofits may carry out certain income-generating activities such as food drives, charity balls, and booster clubs, but may have to pay taxes on the earnings if they compete in certain ways with private businesses as discussed in Chapter 14.
- ✓ **Nonprofit foundations:** Individuals and organizations may establish private foundations (see Chapter 11 for more on foundations). These are special tax-exempt entities generally run by private individuals to accomplish tax-exempt purposes.
- ✓ **The government:** Nonprofit organizations are often established to carry out state, federal, and local government programs. These organizations may receive tax revenues that are allocated for such programs.

## ***Tax-exempt status***

Nonprofits generally don't have to pay federal income taxes on the funds that they receive from the sources listed in the preceding section. This is referred to as *tax-exempt status*. The requirements for obtaining tax-exempt status are discussed in more detail in Chapter 5.

To receive tax-exempt status, an organization must be operated exclusively for one or more of the following purposes:

- ✓ Charitable
- ✓ Religious
- ✓ Educational
- ✓ Scientific
- ✓ Literary
- ✓ Public safety
- ✓ The fostering of national or international amateur sports competition
- ✓ The prevention of cruelty to children or animals



There are instances where nonprofits are required to pay taxes on some activities that legally compete with the private or for-profit sector. For example, if an organization holds a weekly spaghetti dinner, it's considered to be competing with the local restaurants and therefore must pay taxes on the income from the fundraiser. The money it receives from this fundraiser is called *unrelated taxable business income*. (You can find more information about this type of income in Chapter 14.)

## The bottom line

Even though nonprofits don't exist to generate a profit, they still must keep their eye on the bottom line. They generally have strict budgetary constraints. Nonprofit organizations may accept, hold, and disburse money and may enter into all sorts of commercial transactions. Money and how to manage it is a day-to-day issue for nonprofits.



A more precise term is not-for-profit, rather than nonprofit, and this is often used in legislation and texts.

## Limitations



Because of their privileged tax-exempt status, nonprofits are prohibited from doing certain things that are completely acceptable for their private sector, for-profit counterparts. For example, nonprofit organizations usually lose their coveted exempt status if they do any of the following:

## Why don't charitable organizations pay taxes?

The rationale that the courts have long used in exempting charitable organizations from taxation is that such entities often relieve the government of having to provide many similar services (feeding the poor, providing health and safety services, educating the public and promoting business cooperation). In particular, Congress figures that charitable organizations

also relieve taxpayers of having to pay additional taxes for such services.

Each year thousands of organizations in the United States apply for and receive tax-exempt status from the Internal Revenue Service under Internal Revenue Code Section 501(c)(3), which is discussed more fully in Chapter 5.

- ✔ **Engage in prohibited political activities:** Nonprofits are prohibited from political campaign activity.
- ✔ **Change their operations on a whim:** Nonprofits must adhere to the purposes for which they were established. So, unlike their corporate counterparts, they can't diversify and evolve freely to reflect changing markets or community needs.
- ✔ **Farm out control of their operations:** Nonprofits must be governed by their own boards, and can't have outside management teams.

Ten of the most common ways that nonprofits can lose tax-exempt status are discussed in Chapter 18.

## *Comparing Small Nonprofits to Small For-Profit Businesses*

Many nonprofits have huge missions and relatively small budgets to accomplish them. This imbalance isn't all that different from many private sector businesses, particularly small start-up companies with big future goals. To help you understand how nonprofits function, this section compares them to small businesses, with which you may be more familiar.

### *The similarities*

If you work in a nonprofit environment, you may notice that your organization has the following similarities to a typical small business environment:

- ✓ **Well-defined goals and missions:** Everyone knows what the organization's product or services are.
- ✓ **Limited resources to accomplish goals:** The organization doesn't have unlimited resources, so it must accomplish its goals with the available funds.
- ✓ **Accountability for achieving the mission:** Organizations that fail in their missions generally aren't funded indefinitely.
- ✓ **Criteria for assessing whether goals are met:** Healthy for-profit and nonprofit organizations have created a way of self-evaluating to determine whether the organization is meeting its own goals.
- ✓ **A defined management or governing structure:** Like private corporations and commercial business entities, most nonprofit organizations have boards, management, and various levels of staff that help keep the organization afloat.
- ✓ **Identifiable stakeholders:** Just as private companies must know who their customers are and serve them accordingly, nonprofits must ultimately satisfy the objectives and needs of their various stakeholders.

## *The differences*

Just as there are similarities between nonprofits and for-profits, there are also a few differences. For example, consider the following items, which you'll find in a nonprofit but not in a for-profit:

- ✓ **Third-party funding:** It's rare for someone to just give money to a for-profit business. However donations, grants, and government funding are the norm in the nonprofit world.
- ✓ **Participation of volunteers:** For-profit companies are generally staffed by employees who are hired at competitive wages. However, nonprofit organizations typically rely heavily on the donated time of volunteers.
- ✓ **Stakeholders who don't contribute financially to the organization:** Many of the people who are directly served by nonprofits contribute nothing financially to these organizations. There's a disconnect between the financial viability of a nonprofit organization and the perceived quality of the services or goods that it provides.

## *Surveying the Latest Legal Landscape*

Congressional and Internal Revenue Services (IRS) initiatives, along with more stringent legislation, are causing nonprofits across the country to

assess their compliance with the law and to reconsider decades-old practices. At the helm of this push for change is Republican Senator Charles Grassley of Iowa, who asked the IRS to look more closely at the inner workings of nonprofits. The Pension Protection Act of 2006, which contains provisions that nonprofits need to be aware of, is also an important part of the sweeping change that's occurring in the nonprofit sector.

## *New legal scrutiny over nonprofits*

In 2004, Senator Grassley prodded the Senate Finance Committee to propose legislation that would dramatically increase federal government oversight of nonprofits.

He charged that nonprofit groups and individuals are “exploiting” a vacuum “in the enforcement of the laws governing tax-exempt groups to enrich themselves rather than serve the public.” To this end, Grassley publicly requested that both the Chief Counsel of the IRS and the Commissioner of the IRS's tax-exempt entities division look into what is happening in the nonprofit sector more closely. To regain nonprofit service to the public, Senator Grassley specifically asked requested that the IRS scrutinize the following:

- ✔ **Charges of excessive compensation:** Senator Grassley urged the IRS to aggressively pursue cases where it appears that board members or trustees are receiving overly generous paychecks when taking into account what they actually do. (Flip to Chapter 6 to find out what compensation is appropriate for those who work for a nonprofit organization.)
- ✔ **Unrelated business income:** Senator Grassley questioned whether exempt organizations are abusing tax-exempt status by not paying taxes on income that's unrelated to their exempt purposes. (You can read more about unrelated business income in Chapter 14.)
- ✔ **The tax-exempt status of nonprofit hospitals:** Senator Grassley focused public attention on the issue of whether nonprofit hospitals provide enough charity care or other benefits to deserve their tax-exempt status.
- ✔ **Compliance with reporting requirements by large nonprofits:** Senator Grassley wanted to know how well charities with total assets of \$100 million or more are complying with the requirement that they file their federal informational returns electronically.

Despite this aggressive to-do list, Grassley has not been overly critical of the IRS' efforts to date. In fact, he has publicly praised the agency for its efforts to ensure that charities are complying with the federal law that prohibits them from getting involved in partisan politics.



At Senator Grassley's prodding and after several well-publicized hearings on the subject, the Senate Finance Committee issued draft legislation in 2005. The Committee also agreed to receive legislative recommendations from the Panel on the Nonprofit Sector, which is a prestigious independent group of individuals with expertise in administering tax-exempt entities. The panel's Web site is located at [www.nonprofitpanel.org](http://www.nonprofitpanel.org).



Some of the ideas from Congress and other sources that the Committee discussed included the following:

- ✓ **Increasing IRS authority:** The Committee considered granting the IRS greater enforcement powers to address the perceived violations of tax-exempt status.
- ✓ **Ratcheting up Form 990 filing requirements:** By enhancing Form 990 filing requirements, the committee hoped to increase the transparency of tax-exempt organizations. (Form 990 is discussed in greater detail in Chapter 7.)
- ✓ **Requiring nonprofits to periodically reconfirm their tax-exempt status.**

## Shining the spotlight on some specific charities

Some of the groups that Senator Grassley targeted in his scrutiny of nonprofits include the Edward Orton Jr. Ceramic Foundation in Westerville, Ohio, the Musculoskeletal Transplant Foundation in Edison, N.J., and the National Association of Investors Corporation in Madison Heights, Mich.

According to Senate Finance Committee findings, the organizations generated significant amounts of income that were unrelated to their tax-exempt purpose, but they didn't pay taxes on those funds. Senator Grassley further alleged that key officials of the organizations appeared to be overpaid.

J. Gary Childress, the Orton Foundation's general manager, steadfastly defended his organization's tax-exempt status in the media. Childress denied that Orton violated any laws or

overpaid any employees. He explained that the court had affirmed the IRS's determination of Orton's tax-exempt status in 1971. He explained that Orton didn't have to pay tax on its sales of ceramics because they were related to its charitable purpose of furthering research in the field of industrial ceramics.

Similarly, representatives of the Musculoskeletal Transplant Foundation defended its tax-exempt status by explaining that their organization provides products that for-profit companies do not. "Given the altruistic nature of tissue donation, MTF strongly believes that its tissue banking is a tax-exempt activity that should continue to be performed by nonprofit, charitable organizations and should not be not subject to taxes as an unrelated business activity."

## **The Red Cross versus Senator Grassley**

In December 2006, Senator Grassley took aim at one of the largest and most established non-profit targets in the United States: the American Red Cross. In a well-publicized letter, he asked the Red Cross to explain in detail how its board operates. He requested copies of all board meeting minutes for the past five years, a description of the duties of the board, correspondence and e-mails between board members and its chief executive officer, and copies of the agency's internal evaluations.

In his letter and accompanying press statements, Senator Grassley questioned the effectiveness of the governing board. His demand for an investigation came in response to charges that the agency had responded slowly and inefficiently to Hurricane Katrina and had mismanaged funds meant for victims of the September 11 terrorist attacks.

Finally, Senator Grassley explained that "the name and notoriety of the Red Cross make it essential for those governing the organization to go the extra mile to ensure public confidence not only in the Red Cross but in the nonprofit sector generally."

Here's the Red Cross's response to the publicity:

"We are fully cooperating with the Senate Finance Committee and Chairman Grassley in response to their questions regarding the operations of the American Red Cross. The American Red Cross is committed to learning from our prior challenges and making the necessary changes to improve the delivery of services to the American people.

The Red Cross wants to implement the best corporate governance practices found in the charitable and for-profit sectors. We are encouraged that Senator Grassley, in his letter today, agrees that "there is no daylight between us in that common goal." To that end, the American Red Cross has initiated an independent governance review and will soon host a summit on corporate governance best practices, all with the purpose of developing concrete recommendations.

Because the Red Cross exists to fulfill a vital national mission, we bear an exceptional burden to ensure that we meet and exceed the expectations of those whom we serve and of those who selflessly donate their time, money and blood."

## ***The Pension Protection Act of 2006***

The federal Pension Protection Act of 2006 is the newest legislation that's designed to protect workers' pension rights. This Act contains many embedded provisions for nonprofits, some of which are actually welcomed by the organizations.

### ***Ease of revoking tax-exempt status***

Prior to the Pension Protection Act, once an organization received its determination from the IRS that it had qualified for tax-exempt status under Section 501(c)(3) of the Internal Revenue Code, that status remained in effect forever

unless revoked by the IRS. Now, under Section 1223(b) of the Pension Protection Act, tax status is automatically revoked if the organization fails to file Form 990 three years in a row. Form 990 is the informational return that the IRS requires nonprofit organizations to file. (This form and all its requirements are discussed in Chapter 7.)

### ***Record-keeping requirements***



Save your receipts! Under the new law, no tax deductions are allowed for cash contributions without a receipt, canceled check, or credit card statement. You don't need to mail these things in with your tax returns, but you do need to keep the receipts and other documentation with your copy of the return in case you're stuck with an IRS audit.

The new law also toughens the rules for noncash donations. If you donate items such as cars, clothing, and household goods to a charity, they must be in good condition.

### ***New tracking of tiny nonprofits***

For the last 40 years, the IRS has exempted small organizations from having to maneuver the complexities of IRS Form 990. This exemption meant that the local church bake sale and other programs with annual revenues under \$25,000 didn't have to file anything with the IRS. However, they were still required to comply with state laws. This is no longer true.



With the new Pension Protection Act, these small nonprofit groups are now required to provide the following information to the IRS:

- ✓ The legal name of the organization
- ✓ Any name under which such organization operates or does business
- ✓ The organization's mailing address and Web address (if any)
- ✓ The organization's taxpayer identification number
- ✓ The name and address of a principal officer
- ✓ Evidence of the continuing basis for the organization's exemption from the filing requirements (such as documents verifying its status with state governments)

It remains to be seen what the new IRS "notice" form for small organizations will include. The requirement that organizations offer up "evidence" pretty much assures that some new type of IRS form will be created and required even for the smallest organizations.

*The implications of revocation*

The IRS publishes a new shaming list of the organizations that have had their tax-exempt status revoked due to failure to file returns or notices, which means that donors who make gifts after the lists are published will be denied a deduction. And you know what that means: You'll have some angry donors who will spread the negative news far and wide. As you can imagine, that's not good for an organization's bottom line. As if that bad publicity weren't enough, the organizations also have to reapply for tax-exempt status (not a fun weekend task). If an organization can show "reasonable cause" for failure to file the return or notice, exemption *may be* granted retroactively to the date of the loss of exemption.

## *Focusing on Good Governance*

Institutes and seminars have sprung up across the country to help nonprofits govern themselves more effectively. Many nonprofit organizations are also voluntarily complying with Sarbanes-Oxley, a stringent law passed to govern for-profit corporations. This law was passed in response to the bankruptcies of Enron and Worldcom and was aimed at corporate corruption. Corporations have spent billions to comply with this law. Nonprofits, though legally exempt from most of Sarbanes-Oxley, are facing a confidence crisis of their own due to this far-reaching law. Desperate to avoid the public scrutiny bestowed on the Red Cross and United Way (both of which were caught up in nasty scandals), many nonprofits are adopting Sarbanes-Oxley standards on a voluntary basis. Check out Chapter 13 for more on these corporate standards in the nonprofit sector.