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NONPROFITS: FINANCE

"Uh Oh. It's the End of the Year and We Have Money Left Over!"

11.18.14 | Linda J. Rosenthal, JD

You're a nonprofit. You're panicking.

That November fundraiser was a huge success. You have money to burn. But will your tax exemption go up in smoke on December 31st?

No — so relax.

"Nonprofit" Doesn't Mean Every Penny Must Be Spent

The term "nonprofit" refers to the *classification* of an entity under state law; that is, "for profit" vs. "nonprofit." A for-profit entity is formed for a profit-making purpose; a nonprofit is not.

But it doesn't mean that — by one minute before New Year's Eve — a nonprofit has to spend down every last cent of revenue that year. In fact, a nonprofit *can* make a profit. In other words, even though a nonprofit is not created for a profit-making purpose, it is allowed to make some profits along the way to fund its good works.

State corporate law

Under state law — California's, for example — the key distinction between a nonprofit corporation and a for-profit corporation is the reason why it was formed.

A traditional for-profit exists to make money for its shareholders. (There are now new forms of hybrid, for-profit corporations — social enterprises — but more about that in later posts.)
A nonprofit is different: Its purposes must be "public or charitable" instead of profit-centered for the benefit of private individuals.

Under California law, a nonprofit is allowed to carry on "…a business at a profit as an incident to the main purposes of the [nonprofit] corporation." And, of course, having the good fortune to collect more in donations than is needed in a particular year to cover expenses, is also ok.

Federal tax law

An organization that wants the prized, 501(c)(3), federal tax exemption must first show that it is formed for nonprofit purposes under state law.

Then, it must demonstrate that it is "organized and operated exclusively" for one or more "exempt purposes" — and not for the benefit of private interests.

There is a long paragraph in the tax code with examples of "exempt purposes" — but it boils down to roughly the equivalent of the state's definition; namely, "charitable and public" purposes.

That doesn't mean though, that a nonprofit can never have a surplus. It can receive grants and donations, and can have activities that generate income, so long as these dollars eventually are used for the group's tax-exempt purposes. If there is money left over at the end of a year, it can be set-aside as a reserve to cover expenses in the next year or beyond.

Spending Down All Income is Fiscally Irresponsible

So having some money in the nonprofit's bank account at year's end is not only allowed — it's the prudent way to run the organization.

For instance, if a nonprofit had to spend 100% of its funds each year, it would have no way to pay ordinary operating expenses coming due in early January. There would be a frantic race each December to use existing funds — down to the last penny — for the tax-exempt purposes, followed by a massive fundraising campaign each January 1st.

Maintaining a financial cushion is good money-management and it's legal.

It Can't Really be That Simple, Right?

Right. There are a few "buts."

Generally, a nonprofit can safely make a profit, as long as its primary purpose is to carry on and advance its tax-exempt goals and activities.

But, sometimes, the income from certain types of money-making activities may be taxed. These rules came about because for-profit businesses that ran the same type of profit operations as nonprofits wanted to level the playing field.

So which circumstances will trigger this tax obligation? It all depends on whether the nonprofit makes a profit from a "related" business activity or an "unrelated" business activity.

If the activity is "related" to the nonprofit's stated (exempt) purposes, then the money received is not usually taxed. But if the activity is "unrelated," the profit is subject to a special tax called the "unrelated business income tax."

Those are some fairly complicated rules that we won't cover right now. Here is a handy, comprehensive IRS publication that gives a useful introduction to this complex topic. We'll just point out that nonprofits spend a lot of time and money trying to persuade the IRS that their income-generating activities are related to, and advance, their exempt purposes.

If a nonprofit's unrelated money-making activities get too big and swallow up the charitable goals, then the organization can lose its tax exemption. The IRS comes to the conclusion that it wasn't organized and operated exclusively for charitable purposes after all. There are mechanisms that can be used to address this scenario – including forming a profit making subsidiary or joint venture.

Conclusion

In later posts, we'll discuss each of these topics separately.

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