

BUILDING A BUSINESS

Nonprofit? Not simple

After the Minnesota Supreme Court ruled in December that a small nonprofit day care center had to pay property taxes, many observers began to point to growing confusion about nonprofits. It comes at a time when governments are facing increasing pressure to scrape up funds for education, health care, and other public services.

Forming and operating a nonprofit is not simple. For a better understanding, let's look at some basic characteristics of nonprofits and how they qualify for tax exemptions.

Who defines nonprofit?

We generally think of a nonprofit organization as one that provides a public service to the community. A food bank, for example, receives donations to help feed the poor. By contrast, a for-profit organization sells goods and services to make a profit.

Apart from its informal definitions, *nonprofit* is a legal term embedded in a body of law. Simply put, nonprofit status is conferred by the IRS under Section 501 of the U.S. Tax Code. This code section lists several

religious organizations, and social welfare organizations.

Nonprofit status has advantages, notably certain tax exemptions. Governments grant tax exemptions because nonprofits provide public services and help lessen a government's burden of protecting, educating, and providing for the well-being of citizens.

Another advantage is that nonprofits can apply for government and foundation grants intended specifically for nonprofits. They can also solicit donations from corporations and individuals, who can then turn around and deduct their donations from their income tax.

How to get nonprofit status?

To the IRS, churches and religious organizations are nonprofits under the principle of separation of church and state, as provided in the U.S. Constitution. A child care center operating within a church is a *de facto* nonprofit, unless there are reasons for it to obtain nonprofit status on its own. The church board may decide that a

is best done with a tax attorney. Space does not permit listing all the steps here, but mainly the organization forms a nonprofit corporation as provided by state law and then files an application with the IRS.

Forming a legal entity is essential to transacting business—opening a bank account, owning property, and providing a way for the organization to continue after its founding members pass on. To incorporate, the organization files articles of incorporation with the secretary of state's office.

The articles of incorporation contain provisions that taxing authorities will scrutinize. A few key provisions include the following:

- mission statement that describes the organization's charitable or educational purpose,
- board of directors to guide the organization in its mission and to oversee legal and financial obligations,
- statement that none of the organization's net earnings may benefit any of its officers, directors, or private individuals, except for reasonable compensation for services actually rendered, and
- dissolution provision, naming a public entity that will receive the assets if the organization dissolves.

The application to IRS is critical. The tax exemption granted by IRS applies only to the federal income tax generally paid by corporations on their net earnings. But in actuality, a favorable IRS determination

Need free legal help?

Nonprofit child care centers in Texas can get a free online manual on the Web site of Texas Community Building with Attorney Resources (Texas C-BAR). See www.texasbar.org/ or call 1-800-369-9270.

Nonprofit child care centers in other states can contact their pro bono business program. To find one, contact your local or state bar association.

types of nonprofits: charities such as the Red Cross, foundations such as the Hogg Foundation for Mental Health, professional groups such as the American Medical Association,

separate entity would reduce liability if a child were injured, for example.

Forming a nonprofit organization can be a long, complicated, and expensive process and

opens the door for other tax exemptions.

The most well-known IRS tax-exempt classification is the 501(c)3. To determine whether an organization qualifies, the IRS requires extensive documentation such as bylaws, activity descriptions, and financial statements. The organization must show, among other things, that it operates exclusively for its stated public purpose. In addition, the organization is restricted in lobbying and political activities.

Exactly what kind of 501(c)3?

Within the 501(c)3 classification are subcategories that can have a huge impact on an organization's operation. If a child care center's mission is to provide child care and education, for example, the IRS may classify it as an educational organization or private school. In this case, the requirements include a firmly established and demonstrated policy of nondiscrimination.

As another example, if a child care center's mission is to serve poor families, the IRS may classify it as a public charity. In this case, the requirements include a broad base of financial support from donations, grants, and fees. If two-thirds or more of donations come from one or two families or corporations, however, the IRS may classify the organization as a foundation and treat it differently for tax purposes.

Learn more about requirements at www.irs.gov/pub/irs-pdf/p557.pdf.

Other possible tax exemptions

A 501(c)3 determination is

necessary for other tax exemptions but by no means guarantees them. Here's a summary:

Federal corporate income taxes. Exempt from taxes on earnings from services directly related to the organization's charitable or educational mission, but not exempt on \$1,000 or more from earnings on unrelated goods and services such as selling T shirts.

Taxes on employees, notably federal income tax withholding (FICA), Social Security and Medicare, and unemployment. Not exempt.

State income tax. Depends on laws and regulations of states that have a state income tax.

State business or franchise tax. Depends on laws and regulations of the state. In Texas, educational and charitable nonprofits may be exempt (Texas Tax Code, Sections 171.061 and 171.062).

State and local sales taxes. Depends on laws and regulations of the state. In Texas, religious, educational, and public service nonprofits may be exempt (Section 151.310).

Property taxes. Depends on laws and regulations of the state. In Texas, charitable nonprofits and private schools may be exempt (Sections 11.18 and 11.21).

Maybe tax-exempt. Maybe not.

The Minnesota court's ruling that the Under the Rainbow center in Red Wing was not exempt from property taxes turned on the state's criteria for a public charity—in essence, whether the center provided a free service. It didn't. It charged the same price for every child regardless of the family's ability to pay or eligibility for government support. For

the full opinion, see www.kiplinger.com/members/taxlinks/061308/Goodhue-case.pdf.

In a 1998 case in Austin, Texas, the Circle C Child Development Center was denied a property tax exemption because it didn't qualify as a school under Section 11.21 of the Texas Tax Code. The Texas Court of Appeals, Third District, said the center, which is accredited by the National Association for the Education of Young Children, provided primarily "custodial care," did not keep normal school hours, and did not serve children of school age, except for a couple of hours after school. For the full opinion, see <http://bulk.resource.org/courts.gov/states/Tex.App.03/3644.html>.

The lesson here is that nonprofits can't predict whether they will get a property tax exemption. But the bigger issue may be the need to clarify what a nonprofit is and how much we value the services nonprofits provide.

Circle C's director Michelle Moran, says paying a hefty property tax bill every year essentially reduces the amount of care and education she can provide for working families. Michelle Finholdt, director of the Red Wing center, says she can't afford to pay better staff wages or buy more educational materials. Are these two examples a case of robbing Peter to pay Paul?

In May, Minnesota began taking steps to clear up the confusion for its nonprofits. The legislature set a one-year ban on reversing the property tax exemptions of existing nonprofits and called on legislators to write criteria that would better define *public charity*.