

# A Primer on Nonprofit Organizations

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**S**tate and local governments are increasingly turning to nonprofit organizations to help provide better services to citizens. The nonprofit sector is growing, its capacities are expanding, and its professionalism is increasing in ways that could make it a valuable ally and partner to government.

Although governments and nonprofits share the purpose of serving the public, they are structurally very different. The differences affect how they carry out their day-to-day activities and also how they do business together. Some government agencies or officials may be skeptical of the value of nonprofits, perhaps because of a bad experience or simply a misunderstanding of how nonprofits operate. Misconceptions not only hinder a good working relationship but also prevent the two sectors from benefiting from each other.

To strengthen relationships between governments and nonprofits, the Institute of Government at The University of North Carolina at Chapel Hill and the North Carolina Center for Nonprofits, as part of a joint project funded by the Jessie Ball duPont Fund, have probed into the questions that each of the two sectors is asking about the other. This article presents some of the questions that government officials ask, and offers some answers.<sup>1</sup> The intent of the article is to help those officials better understand how they can work with nonprofits to stretch tax dollars and tap nonprofits' unique capacities to benefit communities.<sup>2</sup>

## 1. What is a nonprofit organization?

A nonprofit organization is a private corporation that works for the public's benefit but is separate and independent from government. Nonprofits are so entwined in communities that it is easy to miss the impact they have on daily life. Consider the organizations with which people come into regular contact—churches, day-care centers, arts programs, human services, youth centers, and the many groups that work to improve the quality of life in communities. Many of these are nonprofit organizations.

Nonprofits may earn revenues like private businesses or government agencies, but they must use any funds in excess of their operating expenses to further the public purposes stated in their charters. Nonprofits may not distribute profits for private gain by individuals. The boards of directors that govern most nonprofits are composed of volunteers who oversee the work of the nonprofits without compensation.

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**T**he nonprofit sector is growing, its capacities are expanding, and its professionalism is increasing in ways that could make it a valuable ally and partner to government.

Since nonprofits are guided by a specific mission, staff and volunteers focus their work on providing a public benefit related to that mission. A nonprofit may serve the entire community, or it may serve a particular group, such as children, older people, or victims of crime. A nonprofit's work may complement or supplement existing government services or may provide services that government does not offer. Governments may choose to contract with nonprofits to provide community services as a way of meeting their own public responsibilities.

## 2. What does "501(c)(3)" mean?

The designation "501(c)(3)" identifies the sections of the Internal Revenue Code (IRC) for one type of nonprofit. The IRC defines twenty-one categories of nonprofits. Each category—501(c)(1), (2), (3), and so on—contains specific restrictions and regulations with which the organization must comply to maintain its tax-exempt status. The largest and most common category of nonprofits, and the only kind to which contributions are tax-deductible, is 501(c)(3).

Nonprofits that fall under Section 501(c)(3) include religious, educational, charitable, scientific, and literary organizations, as well as private foundations. For example, this section includes organizations that monitor streams for pollution, provide literacy training, run after-school care, deliver meals to older people who are homebound, and advocate for low-income citizens.

Members of the Masons, country clubs, or professional associations are part of a different type of nonprofit, one that falls under IRC Sections 501(c)(6) or (7). These sections specify restrictions and privileges unlike those of 501(c)(3). For example, contributions to these organizations may not be taken as charitable tax deductions, nor may membership dues.

Government is most likely to contract with 501(c)(3) nonprofits. These organizations are regulated closely by the Internal Revenue Service (IRS) and must follow a long list of IRS regulations, which include demonstrating accountability for using their money for charitable or public purposes. The vast majority of 501(c)(3) nonprofits work hard to maintain the public trust, are careful stewards of scarce resources, and mon-

itor their tax-exempt activities carefully. Most of the following discussion applies to 501(c)(3) nonprofit organizations.

### 3. Why are nonprofits tax exempt?

Generally, governments collect taxes to redirect private funds toward public purposes. Thus, for-profit businesses contribute to societal needs by paying taxes. (Many companies also make voluntary charitable contributions.)

Nonprofits, however, are created to serve the public. To encourage this work, Congress and the state legislature have set up a legal framework that trades tax exemptions for a benefit to the public (for a summary of the tax status of nonprofits, see sidebar on this page).

Nonprofits annually report details on taxes paid, program activities, and other financial and organizational data to the IRS through federal tax return Form 990. The Form 990 filed by each nonprofit is available to the public, on request, as a means of enhancing the accountability and the transparency of nonprofits. (The nonprofit may charge a reasonable fee to cover copying costs. Many nonprofits' Form 990s now are available on the Web at [www.guidestar.org](http://www.guidestar.org).)

### 4. What roles do nonprofits play in a community? Why do they matter?

The public often thinks of nonprofits as serving needy people—and they do. But they do much more than that. They help connect the community to arts and culture, assist in ensuring public safety, help with economic development, and provide mental health and other social services. Consider the following roles that nonprofits play (also, see sidebar on this page):

- Delivering needed services in their communities—for example, teaching English to new immigrants or serving food to people who are poor
- Providing organized opportunities for religious worship—running churches, synagogues, temples, and so forth
- Educating the public about issues facing society—organizing community forums, publishing newsletters related to women's issues, and more
- Serving as a testing ground for solutions to community problems—for example, developing a model recycling program
- Conducting research—collecting and analyzing quantitative and qualitative data on the effects of welfare-to-work programs, for instance
- Developing public policy options for government to

## TAX STATUS OF NONPROFITS

After filing IRS Form 1023 and receiving approval from the IRS, nonprofits are exempt from federal income taxes on money earned from goods and services directly related to their mission. States use a nonprofit's federal status in making their own determination on exemption.

Nonprofits also may apply for the following:

- Refund of state sales and use taxes in North Carolina
- Exemption from property taxes (administered by counties)

Nonprofits do pay these taxes:

- Social Security
- Medicare
- Unrelated business income tax (on income unrelated to their tax-exempt purpose)
- Some federal excise taxes (for example, import taxes)
- Gross receipts tax in North Carolina (charged, for example, on admission fees to large events)

## WHAT DO NORTH CAROLINIANS LOOK TO NONPROFITS TO DO?

1. Deliver services needed in the community
2. Provide avenues for citizens to get involved as volunteers
3. Serve as a testing ground for solutions to community problems
4. Develop public policy options for government to consider
5. Provide a voice for underrepresented citizens
6. Educate the public on issues facing society
7. Provide structures for citizen participation in a free society
8. Provide opportunities for religious worship

Source: North Carolina Center for Nonprofits.

- consider—for example, organizing parents and teachers to recommend educational standards and goals for the public schools
- Offering avenues for volunteering, from answering phones to delivering client services and serving on boards of directors
- Providing a voice for underrepresented citizens, like people with disabilities
- Creating structures for citizen participation in a free society, such as community advisory panels

The nonprofit sector is having a growing positive impact at local, state, and national levels. As of October 2000, North Carolina had 29,337 nonprofit organizations. Of these, 18,128 (62 percent) were 501(c)(3) organizations. Nationally the non-

profit sector is expanding faster than either business or government. The nonprofit sector also is a major employer. In 1996 it employed 15.9 million people (10.2 million as paid employees and a full-time equivalent of 5.7 million as volunteers). The scale and the scope of the nonprofit sector mean that most citizens are working with, for, or through a nonprofit at some time during each week.

Like government agencies, nonprofits range in size, from large institutions like Duke University or the Red Cross, to small groups like local soup kitchens, shelters, literacy programs, and parent-teacher associations. Regardless of their size, all are important to citizens at large and to the particular people whom they serve.

Nonprofits' budgets also vary in size. Eighty percent of 501(c)(3) nonprofits have annual budgets under \$100,000, and two-thirds have annual budgets under \$25,000.

Although their budgets may be limited, even small nonprofit organizations can have an impact on the community by leveraging other resources—for example, by effectively using volunteers. Many nonprofits bring in additional federal and state dollars, as well as private dollars from foundations and corporations, to improve the community and raise its visibility.

### **5. How do nonprofits help build a sense of community?**

Nonprofits can help build community in a way that governments or private businesses cannot. Since no person or entity can gain financially from a nonprofit's activities, everyone collaborates for the public purpose that the group is organized to serve. The small size of most nonprofits keeps the staff and volunteers close to the people whom they serve in a way that may be more difficult for a large government agency.

Additionally, volunteers become knowledgeable about the mission and the clients that their nonprofit serves. For example, a volunteer providing support to a hospice patient visits with the patient and may learn not only about the patient's needs but also about the illness, the medical procedures involved, side effects, and medical technologies. This volunteer can use that information to help the patient and the patient's family; he or she also can take home the information to help raise consciousness and educate friends. Those friends may be sparked to contribute in their own way by volunteering, counseling, contributing to health research efforts, or providing financial support for local hospice care. Like a pebble in a pond, volunteerism has a ripple effect, producing outcomes that might be too expensive for the government or a business to support directly.

### **6. Local governments cannot do everything. How do nonprofits help address problems in the community?**

Governments are generally responsible for the broad goal of serving the public at large. Nonprofits usually serve particular groups of citizens, so they can become specialists in that area and stay close to the needs of their constituents. Local governments can capitalize on that expertise by seeking information from nonprofits for program development or community problem-solving.

Some of the most innovative public policies in this country have developed from programs and research performed by

nonprofits. For example, in North Carolina the statewide early childhood program known as Smart Start was modeled on a nonprofit program in Greensboro called Uplift. As advocates for their clients and programs, nonprofit practitioners can offer experience, insight, and alternative solutions to problems that the community faces.

Additionally, local government can contract with nonprofits for services that the government probably cannot deliver as efficiently as nonprofits can.

Local government officials also can look to nonprofit leaders as a source of current research or specialized knowledge. Governments can take advantage of these special skills or knowledge by having nonprofit organization members sit on local government boards, such as those that deal with social services, mental health, or health. Nonprofits can bring a voice for, or a perspective on, the community that might not otherwise be represented. They often are able to identify trends and solutions quickly because of their close connections to their client populations. Small nonprofits also are flexible and can adjust quickly as the needs of the community change.

### **7. Who works for nonprofits? How are their staffs compensated?**

Many nonprofits do not have paid staff because of the small budgets mentioned earlier. Other nonprofit organizations operate with a very small professional staff and an active group of volunteers. Big organizations may enjoy a large professional staff and an even larger body of volunteers, depending on the nature of the organization's work. If a nonprofit can use volunteers in an efficient and effective manner that enhances its work, it can multiply the impact of each dollar. Each nonprofit organization, regardless of size, is governed by a volunteer board of directors.

Some nonprofits can deliver the bulk of their programs with volunteers. But larger or multifaceted organizations usually require paid professional staff. It is up to the board of directors to set policies for the nonprofit, hire an executive director, and determine salary schedules and benefits that are competitive.

Because of limited funds, employees of nonprofits often are paid far less than people with comparable skills and education in government or for-profit businesses. According to a 1997 study by the North Carolina Center *for* Nonprofits, among the nonprofits included in the study, 31 percent of the jobs required a college degree, while only 13 percent of the nation's business employees and 21 percent of government workers had college degrees. Yet in North Carolina the average participating nonprofit employee with a college degree earned 35 percent less than the national average for a business employee and 15 percent less than that for a government worker.<sup>3</sup> With increasing demands for accountability, professionalism, and retention of qualified staff, nonprofits are trying to increase staff compensation.

### **8. How do nonprofits operate? Where does their funding come from?**

Raising funds is a constant challenge for most nonprofit organizations because they rely on a variety of funding sources, both private and public. Nonprofits receive financial and in-kind

## TWENTY STAKEHOLDERS OF NONPROFIT CORPORATIONS IN NORTH CAROLINA

1. Board of directors
2. Clients or constituents served
3. Members (who may have voting rights in board of directors elections and/or on organizational policy issues)
4. The general public (to whom nonprofits are accountable for providing a public/community benefit in exchange for tax exemption)
5. Individual donors: annual and periodic donors; people who attend events sponsored by the nonprofit; those who make planned gifts and bequests to the nonprofit
6. Foundations that provide funding—specifically, their boards of trustees and staffs (if they have staffs)
7. Corporations that provide funding—specifically, their boards of directors and staffs
8. Federal government agencies that regulate nonprofits
  - Internal Revenue Service, Tax Exempt and Government Entities Division
  - Internal Revenue Service, Withholdings Division
  - U.S. Department of Labor, Occupational Safety and Health Administration
  - U.S. Postal Service
  - U.S. Social Security Administration
9. Federal government bodies and agencies (if the nonprofit receives federal funding)
  - Congress
  - Office of Management and Budget
  - The agency that provides the funds
  - Other regulatory agencies that have authority over federal grantees or contractors
10. State government agencies that regulate nonprofits
  - Department of the Secretary of State, Corporations Division (for incorporation approval and records)
  - Department of the Secretary of State, Charitable Solicitation Licensing Section
  - Department of the Secretary of State, Lobbyist Registration Section
- Office of the Attorney General, Consumer Protection Division
- Department of Justice
- Employment Security Commission
- Department of Labor, Wage and Hour Division
- Department of Revenue, Sales and Use Tax Division
- Department of Revenue, Withholding Tax Division
- Other agencies involved in legal and regulatory compliance
11. State government bodies and agencies (if the nonprofit receives state government funding)
  - General Assembly
  - State auditor
  - State budget officer
  - The agency that provides the funds
12. Local government agencies that regulate nonprofits
  - County tax assessor (for property tax filing and exemption)
13. Local government bodies and agencies (if the nonprofit receives local government funding)
  - County commissioners or city or town council
  - City or county manager
  - The agency that provides the funds
14. Employees and their families
15. Volunteers
16. National office of the nonprofit's parent organization (if the nonprofit is a local or state affiliate of a national organization)
17. Local affiliates
18. The media
19. Customers other than primary constituents who purchase services, publications, etc.
20. Vendors

—Jane Kendall, president,  
North Carolina Center for Nonprofits

support from government, private individuals, corporations, and foundations. In addition, they may contract with different levels of government to deliver specific government services. Governments can stretch public funds when citizens receive services through nonprofits, leveraging nonprofits' private resources with government dollars.

Some nonprofits generate revenue through fees or sales. If a nonprofit provides a service (such as legal assistance) and charges a fee (often below market rates or on a sliding scale), the revenue helps cover the organization's operating expenses. This type of service can demonstrate an efficient combination of government dollars and nonprofit resources. For example, a government agency may provide a subsidy for a vaccination; the nonprofit may arrange for a volunteer nurse to administer the vaccination; and then a low-income client may pay a small fee for the service. This collaborative effort offers the service at a lower rate than any one entity can provide, while generating revenue to support the nonprofit's operations.

Volunteers are a significant resource, saving nonprofits expenses by performing work, from administration to board leadership. For example, volunteers may answer telephones, stuff envelopes, conduct client in-take interviews, counsel clients, help build homes, provide medical assistance, give legal advice, offer tax services, or teach reading. By contracting with a nonprofit, government benefits from these volunteers as well.

In-kind donations are another resource for nonprofits. For example, hardware stores donate building supplies for a nonprofit to build a home or a shelter. Other businesses may donate a variety of office items, including computers, photocopying machines, printers, and office supplies. All these contributions make a difference by reducing operating costs and allowing the nonprofit to focus its limited funding on delivering services. Consequently the government, private corporations, and individuals all play an important role in helping the nonprofit fulfill its mission.

### **9. How can government officials ensure that a nonprofit will do what they expect it to do?**

If government officials provide funding to a nonprofit and want to ensure that it does what they expect it to do, they should discuss their expectations and agree on outcomes; put both in writing, perhaps using contracts; stay in touch to monitor progress; and request periodic project reports. In effective partnerships, governments do not place unnecessary, burdensome requirements on nonprofits. At the same time, nonprofits do

## **RESOURCES ON NONPROFITS**

For resources related to administration of nonprofits or nonprofits' relationships with government, call the North Carolina Center for Nonprofits at (919) 790-1555 or visit [www.ncnonprofits.org](http://www.ncnonprofits.org). Founded in 1990, the Center is a 501(c)(3) nonprofit that serves as a statewide network and coalition for North Carolina's nonprofit sector, a resource center on effective nonprofit management and leadership practices, and an advocate for the nonprofit sector as a whole. With more than 1,400 member organizations in every part of the state, the Center hosts an annual statewide conference, manages a Board & Staff Helpline, publishes the bimonthly newsletter *Common Ground*, and helps local nonprofit leaders improve their communities. Membership is open to all 501(c)(3) nonprofits in North Carolina and to those applying for that status. Government officials may become Center Associates for \$50 a year and receive *Common Ground* and access to other services.

An organization called Independent Sector serves a purpose similar to the Center's but on a national scale. For more information about the national nonprofit sector, call Independent Sector at (202) 223-8100 or visit [www.independentsector.org](http://www.independentsector.org).

For additional assistance in a particular community, or to arrange local presentations or discussions, contact either of the codirectors of the Project To Strengthen Government-Nonprofit Relationships:

- Gordon Whitaker, Professor of Public Administration and Government, Institute of Government, UNC-CH, CB# 3330 Knapp Building, Chapel Hill, NC 27599-3330, phone (919) 962-0427, fax (919) 962-0654, e-mail [whitaker@iogmail.iog.unc.edu](mailto:whitaker@iogmail.iog.unc.edu)
- Gita Gulati-Partee, Program Director, Public Policy, North Carolina Center for Nonprofits, 1110 Navaho Drive, Suite 200, Raleigh, NC 27609, phone (919) 790-1555, ext. 105; fax (919) 790-5307; e-mail [ggulati-partee@ncnonprofits.org](mailto:ggulati-partee@ncnonprofits.org)

what they have agreed to do with the funding, provide required documentation, and communicate with government partners to solicit, retain, and renew their support.

Nonprofits are accountable to a variety of public and private entities. Like a corporation that is monitored by its shareholders, and like a government that is monitored by its taxpayers, a nonprofit is held accountable by all its stakeholders (see sidebar, opposite). These stakeholders include its board of directors, the people whom it serves, the IRS, private and public funders, volunteers, and the community at large.

**Internal accountability.** People within the organization have duties that hold it accountable. The nonprofit's board of directors (composed of professionals, community leaders, and constituents) oversees the organization's operations and ensures that its actions are in line with its mission. Like a city council or a board of county commissioners, the nonprofit's board of directors looks at what the organization is doing and how it is using its funding. The directors have a legal, fiduciary duty to ensure that all funds are used in accordance with the organization's primary purpose. The board members bring with them their skills and expertise to ensure that the nonprofit conducts business properly. Also, the board is responsible for strategic planning for the organization's future.

**External accountability.** In addition, nonprofits are held accountable by the foundations or other sources (such as the government) that provide them with funding. These sources often require program reports and audits to ensure that the funds are being used to serve the intended purpose. A nonprofit is held accountable through budgets, program evaluations, annual reports, and external audits by a certified public accountant (CPA). For grants and contracts of more than \$300,000, state and federal governments require an additional, special audit, referred to as a “yellow book” audit. Yellow-book audits are complicated and expensive, and finding a CPA firm that will do them is difficult. For grants and contracts between \$15,000 and \$300,000, North Carolina state government requires a sworn statement specifying how all government funds have been spent.

**Accounting standards.** Governments and nonprofits frequently differ in how they keep records, make reports, and evaluate performance. Public officials follow detailed accounting practices from the Government Accounting Standards Board (GASB). Nonprofit financial and evaluation practices are subject to accounting standards from the Financial Accounting Standards Board (FASB). Since nonprofit accounting practices are different from those of governments and may be unfamiliar to local government officials, some government officials may think that nonprofits are not keeping track of their money in standard, generally accepted ways, when actually they are complying with a different set of standards.

**Disclosure and IRS requirements.** Nonprofits are accountable to the IRS and to state tax authorities. Nonprofits with gross receipts of more than \$25,000 must complete an annual Form 990, which reports financial data and other information. Nonprofits that file Form 990s must produce copies of the documents on request. The IRS routinely audits nonprofits, as it does private corporations and individuals, on the basis of random selection or referral.

Just like corporations, nonprofits also must abide by all federal, state, and local laws and regulations related to Social Security (for example, completing and filing W-2 and W-3 forms) and immigration (for example, completing and filing I-9 forms, which verify employees’ citizenship), and they must pay any required payroll taxes. Unlike their counterparts in the business world, nonprofits also must do the following:

- Receive and maintain tax-exempt status (by filing IRS Form 1023 and subsequently conducting activities consistent with their exempt status)
- Comply with limitations and prohibitions on expenditures or activities

- Follow requirements regarding the tax deductibility of contributions

Additionally, any nonprofit that intends to solicit contributions in North Carolina must first obtain a “charitable solicitation license” through the Charitable Solicitation Licensing Section of the North Carolina Department of the Secretary of State. Licenses must be renewed annually.

## **10. Besides providing financial support, how can local governments improve their work with nonprofits?**

Local governments can work more effectively with nonprofits by sharing information about government priorities, funding opportunities, and expectations for reporting and accountability on government grants and contracts. They can streamline their application and reporting processes and coordinate those processes with other local grant makers, such as the United Way, to cut down the duplication of effort by nonprofits. Further, they can encourage their employees to volunteer, give to United Way or other federated campaigns, and conduct drives for goods needed by nonprofits.

To get a firsthand perspective on nonprofit management and governance, elected officials and government employees can serve on nonprofits’ boards. At the very least, they can make site visits, ask to be on mailing lists, and invite nonprofit organization leaders to serve on public boards and to participate in important meetings and discussions.

Local governments also can make in-kind resources available to nonprofits. They can donate used furniture or office equipment, provide office or meeting space, and allow nonprofit organization staff to attend training opportunities offered through county departments. Further, they can allow nonprofits to tap the professional expertise of government staff through informal conversations or participation on ad hoc committees.

Local governments and nonprofits independently gather information on their community, and both can learn and benefit from sharing relevant findings with each other. For example, if employees of the court system see an increase in domestic violence cases, they might find it helpful to talk to staff of battered women’s shelters or advocacy nonprofits to ask if they are experiencing the same trends, and to explore causes and solutions. Such partnering and communication allow both the nonprofit and the local government to pool human and financial resources for the benefit of the community. Through greater interaction, government and nonprofit leaders will see that they share goals and challenges, and that together they can serve the common good.

*For sources of more information on nonprofits, page 35.*

## **Notes**

1. The author thanks Kate McGuire and Emily Crowder for their contributions to the article.

2. A parallel publication, *TWENTY QUESTIONS NONPROFITS OFTEN ASK ABOUT WORKING WITH LOCAL GOVERNMENT*, by Lydian Altman-Sauer, Margaret Henderson, and Gordon P. Whitaker, is available from the Institute of Government. Excerpts from it appeared in a four-part series in the North Carolina Center for Nonprofits’ bimonthly newsletter, *COMMON GROUND*, Mar.–Apr. through Sept.–Oct. (2000).

3. Data on nonprofit jobs and employees are from N.C. CENTER FOR NONPROFITS AND THE MANAGEMENT CENTER, *COMPENSATION AND BENEFITS IN NORTH CAROLINA’S NONPROFITS: A REPORT OF PRACTICES IN 501(C)(3) ORGANIZATIONS* (Raleigh: N.C. Center for Nonprofits and The Management Center, 1997). Data on business and government employees’ salaries are from the same source, which gave its primary source as data from 1990 U.S. CENSUS OF POPULATION AND HOUSING, adjusted 3 percent annually for inflation.