

# nonprofit agendas

JUNE/JULY 2011



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News for Nonprofits

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# Worker status: What you decide may cost you

If you're like many nonprofits, you've started engaging more independent contractors over the last few years to handle some of the workload of your downsized staff. But there's a hitch: According to the IRS, the misclassification of workers as independent contractors (rather than employees) accounts for \$53 billion to \$300 billion in unpaid taxes each year. This sum could help reduce the burgeoning national deficit, among other things, so the agency has been zeroing in on misclassification as a revenue raiser.

## WHAT'S THE BIG DEAL?

If a worker is an *employee*, your nonprofit must provide a Form W-2 annually and:

- \* Withhold income tax and the employee's portion of Social Security and Medicare taxes from the employee's pay, and
- \* Pay the employer portion of Social Security, Medicare and unemployment taxes on the employee's wages.

If a worker is an *independent contractor*, your nonprofit generally should provide a Form 1099-MISC, which reports the amount you've paid to the person that year. The independent contractor is responsible for paying employment taxes (both the employee and employer portions) and income taxes on his or her own.

While the IRS generally should receive the same amount of total income and employment taxes regardless of whether someone is an employee or an independent contractor, it has found that it's more difficult to collect from independent contractors. Thus, the agency tends to favor employee status.

## HOW DO YOU KNOW?

To determine whether a worker is an employee or an independent contractor, you must consider your nonprofit's degree of control and the person's level of independence. The IRS has assembled a number of questions to help employers decide. Commonly referred to as the "20-factor test," the questions revolve around:

1. Behavioral control — whether your nonprofit has the right to control the individual and how that person performs his or her duties,
2. Financial control — which aspects of the business relationship your organization controls, and
3. Type of relationship — whether there's a written contract between the individual and your organization, and if the person receives employee benefits.



## Write it down

Keeping good records on your employees and independent contractors is imperative, not only because of the potential for an audit, but also in case one of your workers challenges his or her status as an independent contractor. In either scenario, you'll already have all of the facts on hand to respond to IRS questions.

Document the facts and circumstances surrounding each decision to classify a worker as an independent contractor and not an employee. You can refer to the IRS's 20-factor test (see main article) in the notes. Also consider keeping files on independent contractors with your employee files for support in case the IRS sends you a blank Form SS-8 or the organization is pulled for an IRS audit. Include any contracts and invoices in the contractor's file.

Here are a few of the most applicable IRS factors, and what a nonprofit's responses might indicate:

**Instructions.** Workers who are required to comply with someone else's instructions on when, where and how they complete the work are typically employees.

**Training.** An organization typically trains its employees on the "how-tos" of the job, but independent contractors are expected to already know how to do the job. So, if training is provided to the workers, this could indicate that they're employees.

**Hiring, supervising and paying assistants.** Independent contractors must pay their assistants. If the nonprofit is supervising and paying a worker's assistants, the worker typically is an employee.

**Setting work hours.** If a worker has the ability to set his or her own daily hours (within reason), that person typically is an independent contractor.

Other factors in the IRS "test" include whether the person works for more than one business at a time and is paid by the hour, week or month (vs. by the job).

## WHAT ELSE CAN YOU DO?

If you're still unsure whether an individual should be classified as an employee or an independent contractor, you can complete Form SS-8, "Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding," and the IRS will decide for you. The process is free, and it typically takes six months or more to receive the determination.

Here's an example of when Form SS-8 could come into play: The Lucky Kids organization thinks that its handyman, Andy, who provides lawn care, plumbing and other repair and maintenance services, is an independent contractor. So the organization doesn't withhold taxes on his income, pay the employer portion of employment taxes, send him an annual Form W-2, or provide him employee benefits.

*The IRS has found that it's more difficult to collect from independent contractors. Thus, the agency tends to favor employee status.*

Andy, on the other hand, believes that he is an employee. He requests that Lucky Kids provide medical benefits and withhold income taxes on his wages.

Either Lucky Kids or Andy can complete and submit Form SS-8 to prompt the IRS to determine Andy's status. It doesn't matter who initiates the request — the IRS will contact the other party and ask it to complete the form. This process gives both parties an opportunity to explain why the worker should be classified as an employee or as an independent contractor.

The IRS also allows a determination for a class of similar workers. Let's say that the Help the Residents organization provides housing for low-income individuals and uses seven handymen to maintain the properties. Instead of completing Form SS-8 for each handyman, Help the Residents can file Form SS-8 for one individual to represent the group of workers.

If your organization receives a Form SS-8, it's imperative to fill it out and return it by the due date. Failure to respond to the IRS's request won't prevent a determination, even though your nonprofit's input could be crucial to the outcome.

Keep in mind that, if the IRS deems that a misclassification has occurred, your nonprofit

could be held liable for all of the misclassified person's employment taxes — plus interest and penalties. And if the agency finds willful negligence (the organization knowingly misclassified the worker), it can double both the withholding and the employee portion of the Social Security taxes.

### BE CERTAIN

If your organization uses independent contractors, evaluate these relationships to determine whether the status for each individual is correct. Even if you've used an independent contractor for a few years, re-evaluate that person. Make sure that his or her circumstances haven't changed in a way that might jeopardize the independent contractor status. \*

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# When should you forgo a special event?

Special events are a typical way for nonprofits to raise funds. Most often, the donor receives a direct benefit from the event, which is often a dance, dinner, auction, tournament or gaming activity. Many nonprofits rely on these events to raise large amounts of money in one fell swoop and increase public awareness of their organization at the same time.

### A STAKE IN THE EVENT

Your organization, for example, might host a "medieval dinner" that would likely cost about \$50 per person at a local venue. But your nonprofit charges \$100 per person to attend. Half of that fee represents the cost of

the participant's direct benefit — dinner with entertainment — and the other half is a contribution to your charity.

But how do you know if an event will be worthwhile? To make a sound decision, take it one step at a time.

### STEP 1: MAKE A BUDGET

Planning and holding a successful event is a process that should start with a budget. Then, estimate what you anticipate the revenue to be. If the costs are likely to be greater than the revenue, you might want to forgo the event altogether.

## STEP 2: DEVELOP A MARKETING PLAN

You need to determine the target audience for the event, and the best way to reach that audience. For example, many seniors could be drawn to a “bingo night.” In this case, they’d more likely read about the event in the local newspaper than on your nonprofit’s blog. On the other hand, you might want to use a variety of digital media to reach the diverse audience you hope will attend your medieval dinner.

*Take a look at ticket sales: Did you bring in the amount of money you had anticipated?*

## STEP 3: ACCOUNT FOR EVERYTHING

It’s important to track all of the event’s costs to arrive at an accurate net profit amount. Using the medieval dinner example, costs could include:

- \* Amounts paid related to the direct benefit that the participant receives, such as food, drinks and giveaways, and
- \* Amounts paid to advertise and market the event as well as to hold it — for printed invitations, rental space, wait staff and so on.

Track each of these expenses separately: It will make it easier to evaluate the event’s success.

## STEP 4: EVALUATE THE EVENT

After the event, your nonprofit’s management and board should review a detailed statement of the revenue and expenses, and compare them to what was budgeted. Take a look at ticket sales: Did you bring in the amount of money you had anticipated? Was the attendance worth the amount of planning and organizing that went into the event?

Next, evaluate the event itself. Did your silent auction or raffle raise the expected amount of money? Did you make more than the fair

market value of the items donated? Finally, look at all of the unexpected expenses. Were these “one-time” or “special” costs that aren’t likely to occur yearly, or are they recurring? The answers to these questions can help you determine if the event was a true success.



Also consider the following factors when determining if an event is worth repeating.

**Past attendance trends.** Has your organization consistently had a low turnout at this event? If that’s the case but you still think it has potential, consider giving each board member and management a minimum number of tickets to sell. Also take a hard look at your marketing plan — have you done enough?

**Economic difficulties.** The tough economy should also be a consideration. Many organizations are opting to forgo events for one or two years for this reason alone.



**Changes in your organization.** Has top management changed or is there a new board in place? This may affect everything from the type of event you hold to how much you can budget for it.

Taking all of these items into consideration — along with the event's past financial performance — will help you predict whether it will be successful in the future. And that should help lead to your final decision about whether to hold it or not. \*

## Operating reserves

# Checking your safety net

During the last recession many nonprofits turned to their operating reserves to keep from going under. As your nonprofit prepares for those inevitable hard times in the future, you need to be clear about which — and how many — assets you can peg as operating reserves.

### Know the boundaries

An operating reserve is the unrestricted and relatively liquid portion of your nonprofit's net assets. Operating reserves don't include only cash or cash equivalents, because that would make it a working capital reserve, which is created to ease routine cash flow swings. Operating reserves are for emergencies.

Endowments and temporarily restricted funds shouldn't be viewed as operating reserves — nor should net assets tied up in illiquid fixed assets used in your operations, such as buildings and equipment.

An operating reserve is more long-term in nature. It generally spans a period of years and comes from operations that create a surplus, such as unrestricted contributions, investment income and a budget surplus.

### Customize the size

Nonprofits with diverse funding can typically maintain smaller operating reserves — say for less than three months of expenses. But for most nonprofits, three to six months of operating expense can be viewed as a “safe harbor.” This would enable the organization to continue as usual during a brief transition in operations or funding, or, in the worst-case scenario, allow for an orderly winding up of affairs.

An operating reserve of more than six months of expenses provides greater flexibility. It might give the organization, for example, funds to pursue a new program initiative that's not fully funded.

### It all depends

How much you should keep as operating reserves depends on your organization. Generally, if your nonprofit depends heavily on only a few funders or government grants, you'd benefit from a larger reserve. Likewise, if personnel costs make up a significant part of your expenses, you should build a heftier reserve. But if these factors don't apply, a smaller reserve would likely suffice.



# NEWS FOR NONPROFITS

## BEWARE OF ACH FRAUD

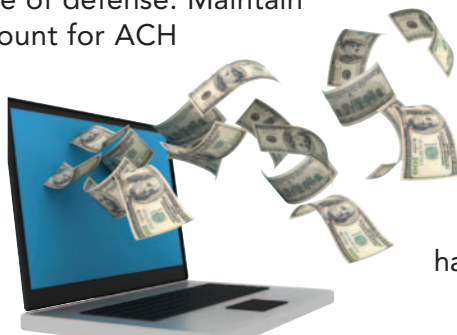
Your organization could lose thousands of dollars each year to Automated Clearing House (ACH) fraud, if you're not careful. This crime, which involves transfers from a third party to your nonprofit's bank account, is on the rise in all sectors because of the expanded use of Internet banking.

How does it work? Your organization receives an ACH deposit of funds from a government agency. A week later, your nonprofit attempts to move a large sum from that account to another account. But the bank notifies you that there aren't enough funds to make the transfer. How can that be?

You investigate and learn there have been a large number of ACH withdrawals, all under \$10,000 — and no one from your organization has made them. The FBI gets involved and discovers that the money has been transferred to overseas accounts. Your nonprofit has become a victim of ACH fraud. And worst of all, your bank has no obligation to reimburse.

ACH debits are electronic withdrawals such as direct payroll deposits and debit payments of bills. They're a relatively simple way to move money, but there's risk attached. For example, unlike with check and credit card transactions, your nonprofit may have no recourse to recover the loss and must notify the bank of the fraud within 24 hours.

But there's a first line of defense: Maintain a separate bank account for ACH debits and credits. In addition, monitor and reconcile balances and transactions daily. ACH debit blocks and debit filters are banking



tools that can help you monitor transactions. Cybersecurity insurance provides additional protection against loss. \*

## PRECAUTIONS BEYOND THE CONFLICT OF INTEREST DOCUMENT

Many nonprofits can answer "yes" to the Form 990 question about having a written conflict of interest policy — the document is handed out once a year to board members and employees. But can they truly answer yes to the related question about regularly and consistently monitoring and enforcing that policy?

At a minimum, nonprofits should annually distribute a conflict of interest questionnaire to directors, officers and key employees. It's also a good idea to remind board members at the start of every meeting that, should a conflict arise, they should bring it to the board's attention. Last, implement procedures for dealing with conflicts, including a "decision tree" for handling different types of conflicts. \*

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