

Your Guide to Understanding Nonprofit Payroll

WHEN YOU THINK OF A NONPROFIT ORGANIZATION, you might picture an army of volunteers graciously donating their time without pay. In reality, nonprofits run much like corporations with paid employees and regularly scheduled paydays. They face challenges similar to for-profit businesses like accurately withholding payroll taxes while also facing obstacles unique to nonprofits such as staying within a tightly limited budget, using grant money for certain payroll expenses, and determining reasonable executive compensation. While all this may sound overwhelming, proactive research and preparation can help make understanding and implementing [nonprofit payroll](#) easier. Here's a look at what leaders of nonprofit organizations need to know.

Withholding Payroll Taxes

One of the most common misconceptions associated with nonprofits is that they don't pay employees and therefore don't pay payroll taxes. Nonprofits have employees on staff, and despite having tax-exempt status, they're subject to the same payroll taxes as for-profit organizations. They must withhold federal income tax and FICA (Social Security and Medicare) taxes from employee paychecks as well as pay the employer portion of FICA taxes.

Unlike for-profit employers, [501\(c\)\(3\) nonprofit organizations](#) do not pay Federal Unemployment Tax Act (FUTA) taxes, an employer-only payroll tax. It is important to note that not all tax-exempt nonprofits are 501(c)(3) organizations. Nonprofits without 501(c)(3) status are required to pay FUTA taxes to the federal government. To be eligible for 501(c)(3) status, a nonprofit must apply for an Employer Identification Number (EIN) and file [Form 1023](#).

State Unemployment Tax Act (SUTA) tax rules vary by state; however, nonprofits can elect to forgo quarterly SUTA tax payments in favor of paying the state directly for unemployment benefits paid to their former employees.

There are other essential considerations when it comes to nonprofit payroll taxes:

- Any nonprofit that pays an employee less than \$108.28 in a calendar year doesn't need to withhold FICA (Social Security and Medicare) taxes from that employee's wages.
- While you might like to reward your volunteers, be careful not to offer rewards that are taxable. Stick to perks that are required for volunteers to complete their work, such as parking passes, on-site meals, educational training, etc. If you do convey a gift, you must withhold taxes, and the volunteer must report the value to the IRS as taxable income.

Tax laws frequently change, so closely monitor updates to maintain tax-exempt status and remain compliant.

Using Grants to Pay Employees

Nonprofits often apply for grants to fund specific projects that support their overall mission.

Grants can be used to cover payroll expenses

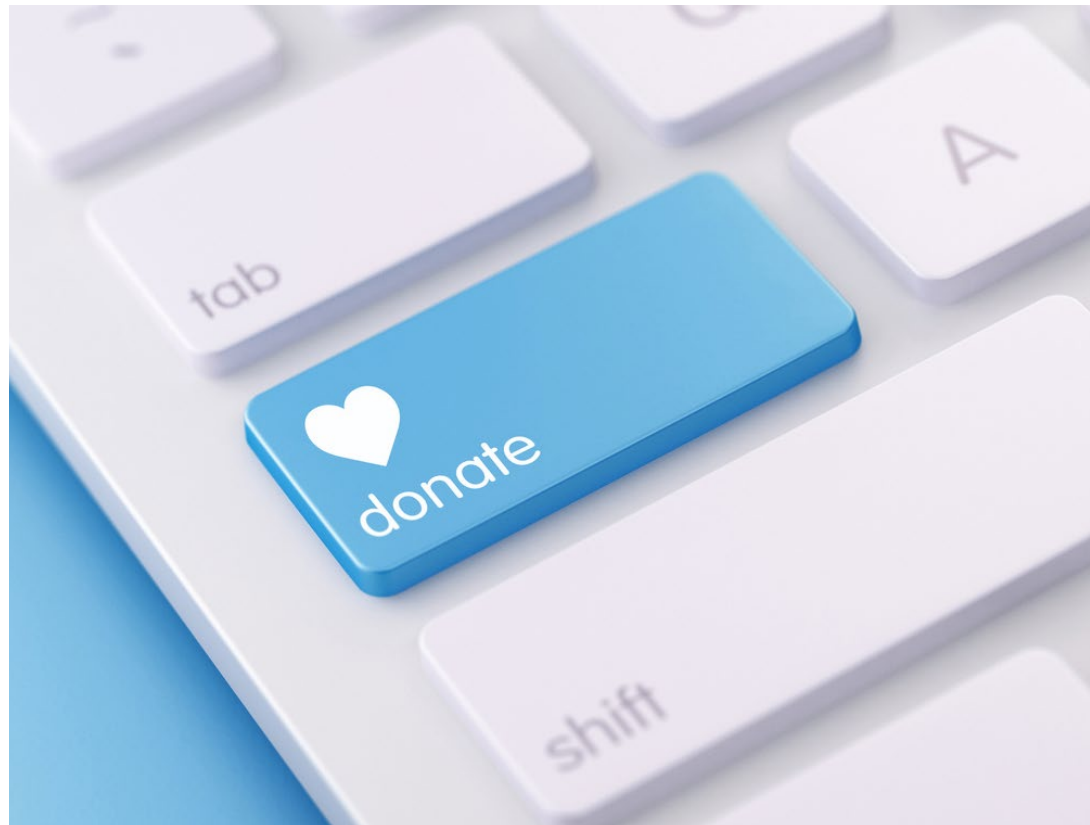
for certain members of staff and their work on projects related to the grant.

Employees whose wages are paid by a grant must track their time and activities performed back to their specific grant. Some of the work they perform in a given pay period might qualify for the grant dollars, and some may not, so tracking becomes important.

One method to track payroll expenses to grants is to utilize

a time system that allows the employee to track time spent on grant-related work via a mobile app. The employee's time information is captured in real-time, and the data flows to the payroll application.

This makes it easy to report on payroll expenses connected with a specific grant. The administration can run reports to see payroll expenses allocated to the grant, and those expenses can then flow to a designated general ledger account in their accounting system.



Reviewing Executive Salaries

Officers and directors of nonprofit organizations must meet the IRS requirements of reasonable compensation. According to the IRS, reasonable compensation is "the value that would ordinarily be paid for like services by like enterprises under like circumstances."

Reasonable compensation takes into account total compensation, including wages, fringe benefits, PTO, professional development costs, bonuses, health insurance, and more. While many nonprofits operate with very small payroll budgets, those with highly compensated employees should regularly review salaries to ensure compliance with IRS rules.

Managing Minister Pay

For religious organizations, a specific type of nonprofit charity, minister pay is handled differently than pay for other employees. Ministers are typically set up as employees of the tax-exempt organization, though in some cases, ministers may be considered self-employed if certain requirements are satisfied. Like other employees, ministers are paid a salary that is subject to income tax, however, there are some differences.

- Ministerial employees are considered self-employed for purposes of calculating Social Security and Medicare tax, meaning the nonprofit does not withhold those taxes from the minister's pay, and the employee is responsible for paying both the employee and employer portions of the tax. Ministers can request an exemption from self-employment tax from the IRS.
- Minister pay may include housing or a housing allowance. This amount is reported by the religious organization on Form 990-T and is excluded from gross income for income tax purposes. However, as with wages, housing allowances are subject to self-employment Social Security and Medicare tax unless the minister has been granted an exemption.

There is a way 501(c)(3) religious organizations can request exemption from the employer portion of Social Security and Medicare taxes on all employee wages. If they are granted that exemption, all employees of the organization will be responsible for self-employment taxes, paying the employee and employer portions of the tax.

For more information on minister pay, see [IRS Publication 517](#), Social Security and Other Information for Members of the Clergy and Religious Workers.

Assigning Payroll Tasks

Recruiting and retaining employees is challenging when you are working with a limited budget. As a result, employees at nonprofits often end up performing more than one job function.

Unlike larger corporations that can hire dedicated HR and payroll staff, nonprofits might have payroll managed by someone who has another role within the organization. That shouldn't be a problem unless the individual managing payroll does not have the proper experience and training. Payroll can be complicated and put your organization at risk if you do not comply with federal, state, and local tax laws.

For security reasons, you also want to be sure that no one individual can enter, approve, and process payroll for your organization. You should always have a second individual [verify all payroll data](#) prior to processing and issuing checks or direct deposits.

Filing Annual Returns

Most nonprofits recognized as tax-exempt are obligated to file an annual information return with the IRS. There are exceptions for certain religious organizations, schools, and political organizations.

The purpose of this reporting is to allow the IRS and the general public to audit nonprofit operations and to maintain tax-exempt status. Form 990, *Return of Organization Exempt From Income Tax*, requires a considerable amount of data, including payroll taxes, number of employees, and executive compensation. Forms for smaller organizations require less information.



- Form 990 (for organizations with gross receipts greater than or equal to \$200,000 or total assets greater than or equal to \$500,000 at the end of the tax year)
- Form 990-EZ (for organizations with annual receipts of less than \$200,000 and total assets at the end of the year less than \$500,000. This group has the option to file Form 990 instead.)
- Form 990-N (for small organizations with annual receipts less than or equal to \$50,000) This form must be filed electronically. Certain types of organizations are ineligible to submit this form.
- Form 990-PF (for private foundations, including nonexempt charitable trusts treated as private foundations, regardless of financial status)
- Form 990-T (business income tax return to report unrelated business income)
- Form 990-W (to report estimated tax on unrelated business taxable income)

Taking the time to accurately complete these forms each year is important. The IRS will reject paper and e-file returns that are incomplete or if the wrong form has been filed. Organizations may be assessed penalties for late forms and may put their tax-exempt status at risk if they do not file for three years.

Understanding the ins and outs of nonprofit payroll means realizing that in many ways, they're similar to a for-profit business while also having their own unique challenges. From properly compensating employees to diligently reviewing salaries and reporting their earnings to managing grants appropriately, there's a lot on a nonprofit's plate. Armed with the right knowledge, however, nonprofits can overcome any payroll challenges and keep their employees energized and inspired to deliver on their organization's mission.



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