Philanthropic Estate Planning

*By Janet Nava Bandera**

Get Exempt–Stay Exempt, Part I: Employment Issues for Code Sec. 501(c)(3) Employers

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As advisors, we are frequently asked by our clients whether they should start a private family foundation. The easy way to answer is to draw a bright line based upon the amount the client wants to give and answer yes or no, it is worth it or not. We have all heard various numbers for that bright line, such as $2 million to $3 million. But, do we really know how much effort and expertise is required to operate a 501(c)(3), whether private or public? Do we know what is involved if the client chooses a private foundation rather than a donor advised fund with the idea that family members can be paid for acting as officers and directors?

The IRS has launched an Internet-based version of its Exempt Organizations Workshop covering tax compliance issues confronted by small and midsized tax-exempt organizations, including charities and churches. The target audience for the free online workshop, *Stay Exempt—Tax Basics for 501(c)(3)s,* is organizations that have no tax experts on staff or have no or limited contact with outside advisors on tax compliance issues.

One of the available tutorials is employment issues. The tutorial covers how to classify workers, how to pay them and the resulting payroll taxes. The highlights of the discussion are set forth below.

Officers and Directors

The Internal Revenue Code defines the *officers* of a corporation—president, vice president, secretary and treasurer—as *employees,* and a 501(c)(3) must classify them as such for tax purposes. This applies if the organization pays the officers to perform their duties as officers. A 501(c)(3) should *not* classify a corporate officer as an employee if he or she performs no services or performs only minor services and neither receives nor is entitled to compensation.

By contrast, the Code defines the *directors* of a corporation—that is, members of the governing board—as *nonemployees,* and a 501(c)(3) must classify them as such for tax purposes. This applies if the organization pays its board members to attend board meetings or otherwise compensates them for performing their duties as directors.

Employee or Independent Contractor

For federal tax purposes, a worker is an "employee" if the employer has the right to *direct and control* the way the worker performs his or her job. Put another way, an employer has the right to tell an employee not only *what* needs to be done, but also *how* it needs to be done.

Independent contractors are self-employed and *carry on an independent trade or business.* They have a high degree of *autonomy.* A 501(c)(3) using the services of an independent contractor has some right to direct or instruct this type of worker, but less than in the case of an employee. The employer has the right to tell an independent contractor what needs to be done, but not *how* to do it.

The IRS has developed three broad categories of questions that analyze the relationship between an organization and those who work for it: (1) behavioral control; (2) financial control; and (3) the relationship between the parties. These categories determine whether a worker is an employee or an independent contractor.

Behavioral Control. To determine how much the 501(c)(3) controls the behavior of a worker consider two key factors: instructions and training. Does the 501(c)(3) provide instructions to the worker by setting the time, place and manner of accomplishing a task, such as selecting which tools or equipment to use? How about *training?* Does the 501(c)(3) provides the worker specific procedures to follow and indicate methods he or she should use in completing the task. If so, the worker is likely an employee.

Financial Control. Has the worker put a *significant* personal *investment* into the tools, equipment or facilities used to do the job? Does the worker maintain a *separate office?* Does the worker *bear the risk* of incurring a financial loss in doing the job? Are there many *unreimbursed expenses?* Does the worker hire and pay helpers? Does the worker advertise and maintain a *visible business location?* Is the worker paid a *flat fee* (rather than being paid on an hourly, daily, weekly, or monthly basis)? If the answer is "yes" to one or more of these questions, the worker has more financial control, which favors classification as an independent contractor.

The Relationship of the Parties. The question to ask here is, how do the organization and the worker perceive their relationship? Consider the following questions: Is there a written contract specifying employee status? Does the 501(c)(3) provide the worker typical employee benefits such as health insurance or a pension plan? Can the 501(c)(3) terminate or discharge the worker or can the worker leave before the task is completed without becoming liable for nonperformance? Are the worker's services a key aspect of the Code Sec. 501(c)(3)'s regular business activities? (For example, a receptionist at a treatment center scheduling patients, answering the phone, and greeting visitors) A "yes" answer to one or more of these questions would favor classification as an employee.

Volunteers

What about volunteers? Generally, workers are volunteers if they serve without compensation for their labors. Are there any tax-related issues concerning them? Yes. From time to time, a 501(c)(3) may provide volunteers with awards or gifts. In general, if these are *noncash items* of nominal value, such as a ham around the holidays, the organization should not count these items as taxable wages. But if the 501(c)(3) gives volunteers *cash* items, such as gift certificates or any other taxable fringe benefit, it must include these items in the volunteer's taxable wages.

Withholding, Paying and Reporting Employee Taxes

What taxes does the 501(c)(3) have to pay? We will start with employees. Like other employers, 501(c)(3)s that pay wages to employees must pay federal employment taxes on those wages. These taxes are federal income tax and FICA taxes (Social Security and Medicare). A 501(c)(3) is exempt from paying FUTA tax (unemployment insurance).

Form I-9, Employment Eligibility Verification. The first employment-related form to complete is the I-9, *Employment Eligibility Verification*. This form required by the Federal Immigration and Nationality Act for all employees hired after November 6, 1986, determines a worker's status and verifies work eligibility. The organization does not have to send it to the IRS but does need to keep it on hand. (The law prohibits employers from knowingly hiring or employing persons not authorized to work in the United States.) Both the 501(c)(3) and the employee must fill out the I-9, and the 501(c)(3) must keep it in its records for three years after the date of hire or one year after the date employment ends, whichever is later.

Federal Income Tax. The 501(c)(3) generally must withhold and pay Federal income tax from its employees' wages. To figure out how much Federal income tax to withhold, employers should ask employees to complete Form W-4, *Employee's Withholding Allowance Certificate*. Ask each new employee to complete and sign a W-4 by his or her first day of work. Keep the form on file, and send a copy to the IRS if directed in a written notice. If a new employee fails to provide a completed Form W-4, the 501(c)(3) should assume single status with no withholding allowances.

FICA Taxes. FICA taxes go toward Social Security and Medicare. The 501(c)(3) must withhold and pay these taxes from employees' wages, with one exception: If the organization pays an employee less than $100 in any calendar year, it need not withhold FICA taxes for that employee. A 501(c)(3) must pay both the amount of FICA tax withheld from employees' wages and the organization's match of that amount.

Paying the Taxes. The 501(c)(3) must pay withheld income taxes, together with both the employer and employee portions of FICA taxes (minus any advance earned income credit or "EIC"), electronically using the Electronic Federal Tax Payment System (EFTPS) or by mailing or delivering a check, money order, or cash to an authorized depositary. Note that some taxpayers are *required* to deposit using EFTPS (*see* e-file for Charities and Non-Profits on the IRS Web site for details).

Earned Income Credit Advance Payments ("EIC"). The EIC is a tax credit for employees whose income falls below a certain level. Those who meet the requirements may receive advance EIC payments with their pay during the year. For deposit purposes, these advance payments reduce withheld income taxes and employee and employer FICA taxes, thereby reducing the Code Sec. 501(c)(3)'s total tax liability. To qualify for advance EIC payments, employees need to give a completed Form W-5, *Earned Income Credit Advance Payment Certificate*, to the 501(c)(3), which must retain it for its records. The 501(c)(3) can use the advance EIC tables in Publication 15 (Circular E), *Employer's Tax Guide*, to determine the correct amount of EIC advance payment.

Reporting Federal Income and FICA Taxes. After the 501(c)(3) deposits the federal income and FICA taxes, it must submit returns reporting that it has withheld and paid them. Just as the 501(c)(3) pays federal income and FICA taxes together, it must report them together—on Form W-2, *Wage and Tax Statement,* and on Form 941, *Employer's Quarterly Federal Tax Return*.

The organization must also send copies of the W-2 to the IRS by the last day of February for the preceding calendar year. To do so, transmit Copy A of the W-2 using Form W-3, *Transmittal of Wage and Tax Statements***.** One copy of the W-2 must also go to the Social Security Administration. It is important to meet the requirements for the W-2; otherwise, penalties may apply.

Do not forget to also report federal income and FICA taxes on Form 941.

FUTA Tax. The FUTA tax is handled separately from federal income and FICA taxes. FUTA provides unemployment compensation to employees who have lost their jobs. This is a tax that employers *do not* withhold from an employee's pay, but they *do* pay it to the IRS. *Note:* Unlike other exempt organizations, a 501(c)(3) does not pay FUTA tax.

Withholding and Paying Employment Taxes of Independent Contractors

A 501(c)(3) does *not* have to withhold and pay federal employment taxes for independent contractors, but there are two important exceptions: incorrect employee classification and backup withholding.

Incorrect Employee Classification. If the 501(c)(3) incorrectly classifies an employee as an independent contractor, and there is no reasonable basis for doing so, the IRS may hold the organization liable for employment tax for that worker. If that happens, the IRS will charge the 501(c)(3) interest and penalties. (*See* Code Sec. 3509 for more information.)

Backup Withholding. There is also the case of backup withholding. A 501(c)(3) needs to get the contractor's Social Security number (SSN) or Employer Identification Number before paying the independent contractor and must include it on Form 1099-MISC, *Miscellaneous Income* (the form a 501(c)(3) must use to report to the IRS what it paid the independent contractor). If the 501(c)(3) fails to do that, it must withhold 28 percent of the independent contractor's pay. This is called "backup withholding," and it safeguards against the possibility that an independent contractor will not report its earnings to the IRS or pay the taxes due on it.

If a 501(c)(3) needs to backup withhold, it must report that backup withholding on the 1099-MISC. If the organization fails to do so, the IRS will hold it liable for the amount of tax it should have withheld from the independent contractor's fee. This amount will come out of the 501(c)(3)'s resources.

Reporting Payments to Independent Contractors and Others

Remember those Board Members who are "nonemployees"? The 501(c)(3) must determine a contractor's business status—corporation, sole proprietor or partnership—by having the contractor complete Form W-9, *Request for Taxpayer Identification Number and Certification*. On this form the contractor will indicate his or her business status as well as his or her EIN or SSN and address. (Both the address and the EIN or SSN must appear on the 1099-MISC.) Completed W-9s are kept in the organization's records, but not sent to the IRS.

Generally, if the contractor is *not a corporation* and the 501(c)(3) has paid the contractor $600 or more (including all fees, salaries, commissions, wages, prizes, awards and other forms of compensation) during a calendar year in the course of the 501(c)(3)'s trade or business, then the organization has a reporting requirement for that contractor. *Note:* The IRS requires that a 501(c)(3) report payments made to health care providers and attorneys, regardless of incorporation.

The 501(c)(3) reports payments to independent contractors and others as "non-employee compensation" on Form 1099-MISC, which it must furnish to *both* the contractor and the IRS. 501(c)(3)s must furnish Form 1099-MISC to the contractor by January 31 and file a copy with the IRS by February 28 for all payments made in the past calendar year. Transmit the 1099-MISC to the IRS with Form 1096, *Annual Summary and Transmittal of U.S. Information Returns*. Failure to comply with the requirements for Form 1099-MISC results in penalties.

Record Keeping

It is very important to keep accurate and complete records for federal income tax, FICA taxes and FUTA tax withheld and/or paid for each employee. The following should be retained for at least four years.

The employee tax records:

- Each employee's name, address and Social Security number
- The total amount and date of each wage payment and the period of time the payment covers
- The amounts subject to withholding for each wage payment
- The amount of withholding tax collected on each payment and the date collected
- The reason, if the taxable amount is less than the total payment
- Copies of any statements furnished by employees relating to nonresident alien status, residence in Puerto Rico or the Virgin Islands, or residence or physical presence in a foreign country
- The fair market value and date of each payment of noncash compensation
- Information about the amount of each payment for accident or health plans
- The withholding allowance certificate (Form W-4) filed by each employee
- Any directive by the employee on Form W-4 for voluntary withholding of additional amounts of tax
- The dates in each calendar quarter on which any employee worked, but not in the course of the business, and the amount paid for that work, if necessary to figure tax liability
- Requests by employees to have withheld tax figured based on their individual cumulative wages and any notice that such a request was revoked
- Form W-5, *Earned Income Credit Advance Payment Certificate*, and the amounts and dates of the advance payments

The FICA tax records:

- The amount of each wage payment subject to Social Security tax
- The amount of each wage payment subject to Medicare tax
- The amount of Social Security and Medicare taxes collected for each payment, and the date collected
- The reason, if the total wage payment and the taxable amount differ

And finally, the FUTA tax records:

- The total amount paid to employees during the calendar year
- The amount of compensation subject to the unemployment tax and, if it differs from total compensation, why
- The amount paid into the state unemployment fund
- Any other information required to be shown on Form 940 or Form 940-EZ

Conclusion

How long did it take you to read to the end of this basic tutorial? Now multiply that 10-fold each month that the 501(c)(3) has employees and/or "nonemployees" to pay, withhold and report the employment taxes. Certainly, the organization can pay a service (who then becomes an independent contractor) to keep track and complete these tasks, but the expenses of that service must be given consideration in the determination of whether to start a small foundation and/or whether to pay the directors/officers of the foundation. This is just one issue to consider in determining the cost and effort of a 501(c)(3).

Endnotes

* The material found herein is attributable to the IRS Office of Exemption Organizations and can be found in interactive, tutorial form at *www.stayexempt.org*.