THE RISING TREND

of Government Contracting by Nonprofits

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An examination of what comprises a nonprofit entity, some basics and unique issues with nonprofit status, as well as a discussion of the increasing role of nonprofits in government contracting.
Although many of the rules and regulations applicable to nonprofits may seem rather foreign to those in the corporate world, traditional nonprofits, such as universities and medical organizations, have been the beneficiaries of government grants and contracts for years. By gaining expertise in a particular area, these organizations have positioned themselves to be ideal candidates for carrying out government programs. For example, an association of medical specialists will publish journals and papers on a specific disease as part of its regular programs. This may make this association the center of knowledge in this area and ideal as a contractor for carrying out drug trials for the government.

Sometimes (and usually with smaller traditional nonprofits) government contracting will become so successful that it becomes the prime function of the organization. Universities will often incubate projects under government contracts. If the project becomes successful enough, the university may divest itself of the program and set up a self-supporting nonprofit organization with the sole purpose of carrying out the contract.

Other nonprofits will be formed “from scratch” for the purpose of carrying out government contracting in a particular niche area. Often, such organizations are formed by owners of existing for-profit contracting firms, who see advantages (such as possible foundation grants) in having a nonprofit structure for certain contracting initiatives.

Over the past several years, there has been a significant increase in government contracts being performed by nonprofit organizations. This activity is being conducted both by “traditional” existing nonprofits and nonprofits formed for the sole purpose of government contracting. Some are even formed as an outgrowth of a successful program by an existing nonprofit.

Nonprofits are generally incorporated and have governing bodies, officers, employees, and similar expenses as for-profit companies. However, the key differentiator between nonprofits and for-profit entities hinges on private inurement. Nonprofits may accrue profits, but these profits may not accrue or inure for the benefit of private parties. Thus, most nonprofits are prohibited under state law from having shareholders to whom profits may be distributed.

Most nonprofit organizations have federal tax-exempt status. Organizations without federal exempt status, although organized under state law as nonprofits, will be liable for income tax. Exempt status is granted by filing an exemption application and receiving a favorable determination from the Internal Revenue Service (IRS). In granting tax-exempt status, the IRS has to be reasonably satisfied that most of the activity of the organization will be related to an exempt purpose allowed for a specific type of organization.

There are more than 20 types of “exempt organizations” defined in the Internal Revenue Code (IRC), ranging from the most common—501(c)(3) charitable organizations—to such esoteric organizations as benevolent life insurance associations and cemetery associations. Some state and local jurisdictions also require an exempt determination at the state level (e.g., the District of Columbia and California), but most follow the federal determination.

Most commonly, government contracting is conducted by 501(c)(3) charitable organizations. However, there is no prohibition against such activity by 501(c)(6) trade associations or 501(c)(4) social welfare organizations. Since most government contracting is conducted by 501(c)(3)s, we will focus on that status here.

How can an organization that only provides services to a governmental entity be considered tax exempt as a charitable organization? The law states that charitable organizations must conduct activities, including those that are charitable, educational, religious, and scientific in nature. However,
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the definition of the term “charitable” was extended in the Internal Revenue Regulations to include such activities that “lessen the burdens of government,”² and thus promote social welfare.

While many nonprofit government contractors do perform services that are educational or scientific in nature, the concept of lessening the burden of government certainly broadens the scope of contracting, which can be considered as a charitable activity in itself. Indeed, there have been several examples of some rather large charitable organizations whose sole function is defense-related contracting—a function that clearly illustrates how the definition of “charitable” has been extended by regulations.

**The Charitable Advantage**

The foremost advantage of being a charitable organization is that charitable organizations are the only entities that can receive tax deductible contributions and grants.³ This enables the charitable government contractor to conduct additional programs outside the strict limits of its government contracting activity.

Currently, there are many private foundations that provide significant grant funding for a wide variety of programs that benefit the general public. Private foundations, which are themselves charitable organizations, are generally precluded from making grants to any non-charitable organization. A charitable government contractor may find that some of these programs are closely aligned with its expertise and current activities. For example, a contractor who provides information management services to the government may be perfectly situated to conduct a foundation grant-funded study on users of federal information. Awards of private foundation grants for such programs can provide much needed revenue diversification, as well as growth. Other public charities may also be willing to provide grants or subgrants for programs they are conducting.

Charitable organizations may also receive charitable contributions from individuals or corporations. Thus, if the organization wishes to set up a program that is educational or truly charitable in nature (e.g., a scholarship program in a particular discipline or funding a program at a university), it may be able to solicit donations from individuals or companies to support this activity. Such programs also serve to greatly enhance the public image of an organization.

Lastly, charitable status may provide a competitive edge when applying for contracts. For example, an organization that is prohibited from providing profits to its owners may be more attractive to government entities than a for-profit organization.

**Unique Issues**

Nonprofit status, in general, and charitable status more specifically, is somewhat akin to living in a glass house—there is a high price to pay in terms of disclosure and transparency for organizations to be exempt from taxation. Nonprofits have come under more and more scrutiny from both the IRS and Congress in recent years. Unfortunately, many recent highly publicized nonprofit scandals have fed the fear that nonprofits require more regulation and oversight.

The Senate Finance Committee has led the way on this front with a series of hearings and reports on the sector, all of which point to an abiding mistrust of the industry’s ability to self-police. The IRS has responded to Congress with more oversight than ever before, and has just introduced a new Form 990 (the information return filed annually by nonprofits and subject to public disclosure), which has raised the amount of disclosure by nonprofits to an incredible new level.

**Excess Benefits**

Arguably, the number one concern for both Congress and the IRS is reasonable compensation and excess benefits. As mentioned previously, nonprofits cannot have shareholders or private inurement. Without some very strict rules in this area, it would be very easy for insiders to take profit out of an organization through unreasonable compensation or other greater than fair market value benefits.

IRC Section 4958, enacted in 1996, provides for draconian penalties to be exacted upon various classes of insiders who profit at the expense of nonprofits. However, these penalties are the responsibility of the insider and not the organization. At a minimum, the penalty is 25 percent of the amount in excess of “reasonable,” on top of having to pay the excess amount back with interest. Organization managers, including board members, can be liable for a tax of up to $10,000 for knowingly approving excess benefit transactions.
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Regulations provide fairly strict guidelines for setting compensation for insiders and valuing most other transactions (e.g., loans, sales, purchases, etc.). As such, organizations should meet a “rebuttable presumption of reasonableness” when entering into financial arrangements with insiders. With compensation, for example, reasonableness is established by having it set by a compensation committee, which does not include the insider, documenting all discussion and conclusions and using comparable salary data.4

These rules also apply to entities the insiders have influence over; thus, excess profits cannot be taken out through a company controlled by an insider. The overarching principle here is that nonprofits should always be paying no more than fair market value for goods or services.

In addition, nonprofit government contractors often have a close relationship (e.g., common management) with a for-profit contracting entity. Such a relationship requires some extra steps. There should be written contracts for all intercompany transactions involving provision of services by one entity for the other. Any services provided by the nonprofit should be at fair market value—an arm’s-length approach with careful consideration of the excess benefits rules of IRC Section 4958.

**Governance and Policies**

Most of the highly publicized nonprofit scandals of the past several years have ultimately pointed to a failure of organizational governance. In its hearings on nonprofits, the Senate Finance Committee pushed hard for a variety of required governance and policy provisions to be put into law. Fortunately, these provisions have not been enacted as of yet.

However, the IRS, in acknowledging governance failures, published best practices guidelines for governance and policy implementation and has, most importantly, incorporated a long series of questions about governance and policies in the new revised Form 990.5 While making it clear that these policies are not required by law, the IRS, in asking a series of “yes” and “no” questions, is making it very clear as to its preferred model.

Since the Form 990 is a public document, anyone who wishes to learn about a nonprofit can simply look up the organization’s filed Form 990 on the Internet.6 As such, government agencies, potential grantors or contributors, newspaper reporters, watchdog groups, and members of the general public can readily find out if an organization has the preferred governance and policy provisions in place, and then determine if the organization is worthy of support.

Some of the best practices advocated on the Form 990 include the following:

- Inclusion of “independent” members on the governing board (i.e., independent in that they are not compensated by the organization);
- Documentation of all board of directors meetings and its committees;
- Review of Form 990 filing by a board or a committee of a board;
- Written conflict of interest policy and procedures for annual disclosure and monitoring;
- Whistleblower and document retention/destruction policies;
- Use of the “rebuttable presumption” procedures for setting officer and key employee salaries; and
- Public availability of governing documents, conflict of interest policies, and financial statements.

While “no” answers to some of these questions will not be that big of a negative, if most of them are answered “no,” the reader could get a bad impression about the organization, perhaps leading the IRS to ask a few questions of its own.

**Other Transparency**

The Form 990 truly makes public much of the information that a private company would be able to keep to itself, including the following:

- Disclosure of total compensation package for officers, directors, and key employees, with even more detail required for those receiving more than $150,000;
- Details about lobbying and political activities;
- Disclosure of financial statement footnotes required by FIN 48 regarding any “uncertain tax positions”;
- Details about any foreign activity;
- Details on transactions with related persons; and
- Disclosure of any related organizations (taxable or non-taxable), as well as transactions with them.

**Unrelated Business Income**

As noted earlier, a nonprofit must conduct most of its activity with programs that support its exempt activity (i.e., those for which it received its exemption determination) in order to maintain exempt status. However, nonprofits may engage in a certain amount of unrelated revenue generating activity without endangering their exempt status. This kind of activity is called “unrelated business income” (UBI). UBI, net of expenses, is taxable at regular corporate rates. If organizations have gross UBI of $1,000 or more, they report and pay tax via Form 990-T.

Certain activities, while not related to the exempt purpose of an organization, are excluded by statute from UBI. The most common exclusion is “investment income”—dividends, interest, and capital gains, although unrelated, are excluded from taxation. Passive rental income (unless from debt-financed property) and royalties are also commonly excluded items. Activities that often cause UBI include advertising income in nonprofit journals or magazines (probably the most common), sale of merchandise unrelated to the exempt purpose, and debt-financed property.
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Even though rental real estate income is generally excluded from UBI, it becomes at least partially taxable when it is leveraged with acquisition debt. Additionally, organizations that have a controlling interest in a for-profit subsidiary may have UBI from payments from the subsidiary for rent, interest, and royalties since the exclusion does not work for such payments from controlled subsidiaries. However, there is a provision that expires in 2009 that makes taxable only the amount in excess of fair market value for such arrangements.

Given the inherent complexity of all of this, it is therefore very important for nonprofits, when engaging in new activities, to carefully analyze such activities for UBI. If unrelated activities become too large a portion of an organization’s activity, then it can lose its exempt status. While there is no fixed line for how much is too much, nonprofit tax advisors will generally raise an alarm when these activities approach 25 percent of revenue or expenses. When this occurs, the easy solution is to simply move the unrelated activities into a taxable subsidiary.

Sales Tax

Many states have an exemption from paying sales and use tax available for 501(c)(3) charitable organizations. Since this varies significantly from state to state, it is advisable to consult with the individual state to determine if an exemption is available and how to attain that status. It should be noted, however, that a state sales tax exemption does not generally exempt a charity from collecting and remitting sales tax to the state for the items that it sells.

“Nuts and Bolts”

This is the one area where contractors familiar with contracting with the government from a traditional corporate platform will feel right at home. Nonprofits face the same everyday challenges that any organization does when contracting with the government. Nonprofits operate under the same contracting procedures and are subject to the same debarment and suspension penalties for wrongful acts.

Contracting naturally starts when the nonprofit submits a bid then competitively negotiates government contract or a sole source government contract. Nonprofits that have government contracts normally have one of the following types of contracts:

- Fixed-price,
- Fixed-price with economic adjustment,
- Fixed-price incentive (performance),
- Cost-plus-fixed-fee,
- Cost-plus-incentive-fee,
- Cost-plus-award-fee, and
- Time and material/labor hours.

When contracting with the government, the nonprofit must invest and maintain strong internal controls to provide for accurate and timely financial reporting. The accounting system must segregate direct costs from indirect costs. The system must identify and accumulate all direct costs to intermediate and final cost objectives. All the costs must be accumulated and reconciled under the general ledger of the organization. The nonprofit’s accounting system must also have a timekeeping system that identifies employee labor by cost objectives and controls that identify and segregate unallowable costs.

The largest expenditure for a nonprofit is labor. Therefore, it is essential for all employees to be sufficiently trained and knowledgeable of the written payroll procedures. The system must allow for...
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daily time recording for all labor charges to government contracts. All time records must be signed by the employees and approved by their supervisors. Unfortunately, this is often a weakness of nonprofits. It is essential that all approvals be visual with an audit trail. Labor hours and dollars for government contracts must be reconcilable to the payroll system. All hours worked on a government contract must be recorded.

Indirect cost rates for nonprofits are another major factor to contracting. The rates should mirror the operation of the organization. A nonprofit’s indirect rate has a pervasive effect on all of its contracts, the levels of revenue, and change in net assets realized. Indirect cost rates should be considered both a strategic and a tactical element of the organization’s business plan. All nonprofits should understand that the indirect rate structure must play a major role in supporting their strategic business model and must not be inconsistent with their business operating models. Major time and resources should be allocated to the development of all indirect cost rates, and if talent does not exist within the organization, outside expertise should be sought after.

Nonprofits that contract with the federal government are subject to audit examination by:

- The Defense Contracting Audit Agency (DCAA),
- The Government Accountability Office (GAO),
- The Office of Inspector General (OIG), and
- Other agencies or departments of the government.

Many nonprofits are required to have external audits that are conducted in accordance with standards applicable to financial audits contained in the government auditing standards, issued by the comptroller general of the United States, the Single Audit Act of 1996, and the Office of Management and Budget (OMB) Circular A-133 “Audits of States, Local Government Entities, and Recipients of Governmental Financial Assistance.” Nonprofits that expend $500,000 or more of federal awards in a fiscal year are required to have a single audit in accordance with these standards.

The federal government contract audit agencies, the largest of which is DCAA, are responsible for providing financial and accounting advice to federal government procurement officials. Procurement officials may call upon agencies’ inspector generals to

- Conduct audits of pre-award surveys;
- Forward pricing proposals evaluations; and
- Perform post-award reviews of cost or pricing data, incurred cost audit, cost accounting standards compliance, and adequacy reviews, system reviews, terminated contract audits, claim audits, and operations audits.

It is important for nonprofits to recognize the level of oversight that will be conducted when contracting with the government. Of course, if contracting is done for state or local governments, the contracting rules for these jurisdictions will have to be considered and complied with.

**Conclusion**

Nonprofit organizations can be an effective vehicle for conducting government contracting operations. There can be significant advantages for an organization that wishes to bring in additional sources of revenue, such as grants or contributions, or that wishes to conduct programs outside of those for which it has contracts. However, establishing and operating a nonprofit organization should not be taken lightly. The nonprofit annals are as full of poorly conceived business plans and failure as any other segment of business. Many nonprofit organizations have gotten themselves and their fiduciaries in legal and/or tax trouble by either not being fully aware of the rules or by making a choice to ignore them.

The formation of a nonprofit organization should be based upon a good business model. Since nonprofits operate under such unique rules, it is extremely prudent to seek out financial and legal advisors with specific expertise in the nonprofit arena. While these experts may not be as familiar with government contracting rules as you may be, they certainly can help you avoid pitfalls with nonprofit legal and tax law. **CM**

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**ENDNOTES**

1. IRC Section 501(c)(3).
2. IRC Regulation 1.501(c)(3)-1(d)(2).
3. IRC Section 170(c)(2)(B).
4. IRC Regulation 53.4958-6.
6. See, e.g., www.guidestar.org, a Web site that publishes all Forms 990.
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