

Introduction

Alvin Lawyer has a long-time client, Sam Goodman, coming into his office today to get advice on starting a new organization to “Save the Chipmunks.” Sam told Alvin that he trusted him and wanted him to handle it. Alvin has always wanted to represent people wearing the white hats, and so he agreed to represent Sam. He has heard that the law affecting nonprofits is complex, but is prepared to spend the time getting up to speed. Where does he start, and what does Sam need to know?

Exempt Status

Nonprofit does not mean tax-exempt. A nonprofit organization can either be taxable or tax-exempt.

An organization can be exempt from income tax under both federal and state law. Often the organization actually has to apply to establish the exempt status with the IRS and/or state taxing authority; in other situations, the organization may be exempt simply by being correctly organized and operated.

There are over 25 different types of organizations that are exempt from income tax on income derived from the organization’s exempt purpose. To be exempt, the organization must meet the qualifications required for that particular type of exemption; the organization must be both *organized* and *operated* for that exempt purpose.

Contributions to the nonprofit are deductible only if they are given to a special type of exempt organization, commonly referred to as a 501(c)(3) organization.

What Is a Nonprofit?—Purpose

Every entity exists for a reason. A business entity exists to ultimately benefit the owners. For example, a corporation exists to benefit the shareholders who own its stock, and a partnership to benefit its partners. But a nonprofit organization has no owners. Instead, it is formed to promote or advance a specific purpose. This

purpose should be carefully defined, as it will control what the nonprofit may or may not do, and it will impact the tax-exempt status of the organization.

Some nonprofit organizations are formed to benefit their members (such as a condominium homeowners association or a social club). These organizations are sometimes referred to as “mutual benefit” organizations. In fact, some of these organizations, even though nonprofit in form, may look a lot like businesses, and the members might look a lot like shareholders. Some mutual benefits may even allow membership interests to be bought and sold. Because the benefit is to the individual(s) and not to society at large, although there may be an exemption from income tax, contributions will not be deductible.

Other nonprofits are formed to indirectly benefit businesses or residents in a particular geographical area, such as a chamber of commerce. Some are formed to benefit a specific type of business or individual, such as professional associations (the American Bar Association and the American Medical Association are two such examples). These organizations may also be exempt from income tax. Contributions to this type of nonprofit may be deductible as a business expense, but again are unlikely to be deductible as a charitable contribution.

If the organization wants to be able to receive tax-deductible contributions, the specific purpose for which it is formed will have to be broad enough to somehow benefit the general public or a significant segment thereof. It cannot be organized or operated for a purpose that benefits only a very limited number of people, even if that purpose is charitable (although such an organization might be exempt from income tax), and it cannot have a primary purpose of benefiting an individual or individuals.

The trick is to draft the purpose so that it is narrow enough to clearly qualify under whatever type of exemption the incorporator wants, while at the same time being broad enough to allow for all expected activities. Alvin might want to suggest to Sam that he consider expanding the purpose of his nonprofit to cover all rodents, and not just chipmunks. On the other hand, “Save the Animals” is probably too broad to satisfy Sam’s desires.

Do You Really Want a Nonprofit?—Control Issues

The purpose of a nonprofit organization is not to benefit an individual owner or owners. Everything must be done to benefit the purpose of the nonprofit exempt organization.

In order to be tax-exempt, there may need to be a clear benefit to the public. To assure that the organization is operated for this “nonprofit” purpose, controls are necessary.

One common method to assure such control is to have a board of directors made up of a majority of “independent” or “disinterested” directors. This means that Sam cannot be the only director; he will have to select others to serve with him. Of course that also means that Sam’s ultimate ability to control the organization will be limited. In fact, it may mean that, at some point, Sam will be outvoted, and perhaps even removed from the board.

Some individuals, when they form a nonprofit, do so with a specific vision of what they want to see accomplished and, indeed, without their energy and vision, the nonprofit is unlikely to succeed. However, if the founder is unwilling to share control, serious consideration should be given to whether a nonprofit organization is the correct form of entity.

A further question has to do with whether the founder expects to receive compensation from the organization. In such a situation, it is even more important that the majority of directors of a nonprofit organization be disinterested, to assure that the organization is operated for the nonprofit purpose, rather than for the private benefit of the founder. If an individual having substantial influence over the organization receives a benefit greater than the value of the benefit he or she provides to the organization, the individual may become subject to substantial penalties, and the organization may lose its exempt status.

The fundamental question is: Will the organization be more effective as a nonprofit, or will its purposes be better served as a business? For example, there are schools run as businesses and schools operated as nonprofits. Both receive a significant amount of funds from tuition; however, only nonprofit schools can also receive tax-deductible contributions. If tax-deductible contributions are necessary to the operation of the organization, a nonprofit may be the only answer. However, if the organization does not need these contributions and the founder wants to maintain complete control over the organization and retain all profits from its activity, he or she might be better served by having a business and forgoing the benefits of nonprofit status.¹

To Whom Does the Organization Report?

The type of filings made by a nonprofit will be discussed in greater detail below. However, it is worth mentioning at the outset that there are at least four different governmental entities that are likely to be involved with your organization:

1. The Internal Revenue Service,
2. Your state taxing authority,
3. Your state charity administrator (generally the Attorney General), and
4. Your state incorporating authority (often the Secretary of State).

There may be other entities as well (such as your local governmental authorities).

As you work with your nonprofit, you should keep this in mind. Often you may find that reports will need to be furnished to each entity (just because you provided information to one does not mean that you have satisfied the requirements of the others). A failure to comply with these requirements may result in suspension or even revocation of your exempt status.

1. For additional thoughts on whether a nonprofit is right for you, see “Get Ready, Get Set” at www.nprcenter.org/resource/get-ready-get-set.

Basic Differences and Similarities²

	Business	Nonprofit 501(c)(3)	Nonprofit other
Can receive tax-deductible charitable contributions	No	Yes	No
Can derive funds from operations	Yes	Yes	Yes
Operated to benefit	Owners	Purpose/General Public	Purpose
Benefit may be limited to certain individuals	Yes	No	Generally yes
Can pay reasonable salaries	Yes	Yes	Yes
Taxed on income	Yes	No, unless derived from business unrelated to exempt purpose	No, unless derived from business unrelated to purpose
Control	Founder can maintain control	Founder, if compensated, loses control	Depends on organization
Profits	Accrue to owner(s)	Must be used for nonprofit, tax-exempt purpose	Must be used for permitted purposes
Owners/Members	Owners' interests can be sold	Members' interests cannot be sold	Depends on organization
Directors	Often are compensated	Majority uncompensated	Depends on organization
Dissolution	Assets go to owner(s)	Assets go to another charitable entity	Depends on organization

2. Note: This chart provides only a basic picture of the similarities and differences; the reality is much more complex. If a particular item is desired, your attorney should be consulted to see if the particular structure works for your organization.