



WHAT IS A NONPROFIT ORGANIZATION?

BY DARREN MOORE

Because my practice focuses on nonprofit and tax exempt entities, when clients call me to seek help in starting a new organization typically they've already made the decision to take the nonprofit form. However, the decision as to whether to take the nonprofit form as opposed to the for-profit form is a critical first choice. And that choice can't be made without first understanding just what is a nonprofit? Stated another way, what makes a nonprofit unique?

Many people consider nonprofit as synonymous with tax exempt or even charitable. Neither is the case though tax exempt and charitable organizations do take the nonprofit form. The vast majority of nonprofits are tax exempt and recognized as charitable organizations described under Section 501(c)(3) of the Internal Revenue Code; however, there are many others that do not fit that classification. Organizations are not charitable such as social welfare organizations, business leagues, professional associations, labor unions, political organizations, and title holding companies to name a few are tax exempt but not charitable. There are also nonprofits that are not tax exempt at all. For example, in Texas, statutory law prohibits the corporate practice of medicine. An exception is a practice in the form of a nonprofit known as an accountable care organization. Such an organization takes the nonprofit form for corporate state law purposes but is not required to be tax exempt (though under certain circumstances it can be!).

Many mistakenly believe the core characteristic of nonprofit organizations is a prohibition from either making or retaining profits, in other words, their revenues must be less than their expenses. This is incorrect and would cause most nonprofits to Close their doors. However, it does have a tinge of accuracy. Profits do lie at the center of nonprofits though the prohibition is not on the organization making or retaining a profit but on profits at the ownership/control level.

At its core a nonprofit is unique because of something referred to as the non-distribution constraint — that is, absent of paying reasonable compensation, nonprofits are prohibited from passing on profits to their owners/controllers. In most states, nonprofits do not have owners at all but are rather controlled by a governing board typically referred to as its board of directors.

Understanding the inability to pass profits on to owners other than as reasonable compensation, what are some of the factors to consider in making the decision whether to take the nonprofit form? Most often the decision is made because the organizational founders desire to seek tax exempt status. Nevertheless, care should be taken to understand that, as referenced above, nonprofit form does not equal tax exempt status.

To qualify for exempt treatment under the Internal Revenue Code (as well as for state law purposes), an organization must be organized and operated for exempt purposes.

For organizations that can demonstrate they are organized and operated for exempt purposes, the founders must consider whether they are satisfied leaving profits at the organizational level and receiving only reasonable compensation. Founders that desire to grow a business and reap the profits either through dividends, bonuses, or upon sale, the nonprofit form would be inappropriate.

A second reason for choosing the nonprofit form is licensing or statutory requirement. The accountable care organization referenced above is an example.

Some founders will choose to take the nonprofit form for the perceived “halo effect.” That is, some view nonprofits as more trustworthy and founders seek to tap into this trust. This could apply in the context of a hospital, daycare or camp. Each could take the for-profit or nonprofit form.

Other factors that could play into the decision (though much more ancillary) are nonprofit postage rates, the number of governing persons (in Texas there must be three members of the board of a nonprofit corporation and must be at least three people involved to form a nonprofit unincorporated association), opportunity for certain types of government assistance, and liability protection under certain circumstances.

Once the decision has been made to take the nonprofit form, the decision moves to what form is the appropriate form. And that will be the topic of the next post.

For assistance in making the decision on whether to form a nonprofit or in forming the nonprofit (whether exempt status will later be sought or not), contact me at dmoore@bwwlaw.com or 817-877-1088.