Can My Business be a Nonprofit?

Entrepreneurs thinking about starting a new business have a number of options to decide among for the business structure. One of the frequent questions that we often field is whether the business, since it is not very profitable, could be turned into a nonprofit. The use of the term "nonprofit" unfortunately leads to confusion about whether the distinction is about having or not having a profit. Nonprofits, like businesses, must have revenues that exceed expenses.

"Nonprofit" is also a catchall phrase for many types of entities with different types of tax treatment and restrictions. This paper will use the term to refer to a public charity under 501(c)(3) of the internal revenue code. There are significant differences between a for-profit entity and a 501(c)(3) nonprofit entity and understanding how each one operates can help you advise a client.

Purpose

The most fundamental difference between nonprofits and for profits is the reason they are formed. Nonprofits must serve public benefits recognized under state and federal law. The types of activities that qualify for tax exempt status are limited. The IRS requires that the purposes be charitable, educational, religious, scientific, literary, fostering national or international sports competition, preventing cruelty to children or animals, and testing for public safety. For profit companies, on the other hand, are founded to generate income for its owners and can engage in almost any type of activity.

Management and Control

A nonprofit is controlled by a governing board of directors or officers. The board is responsible for the management of the organization and ensures that it fulfills its duties. An individual, even a founder, cannot override the board. No one can be guaranteed permanent tenure on a board because the board can terminate the executive director or remove other board members.

Executives of for profit companies have broad leeway in running the company. The focus of management is to maximize profits and protect the company's assets.

Income, Assets, and Liabilities

The property of a nonprofit is permanently dedicated to charitable purposes. There are limitations and restrictions on how nonprofit funds may be used. Cash and other property cannot be used for personal benefit without just compensation. Excessive salaries can cause a nonprofit to lose its tax-exempt status and subject the directors to personal liability. No person owns interests in the property of a nonprofit and income may not be distributed to board members or founders but must be added to the corporate accounts to fund activities consistent with the organization's mission. Nonprofit organizations are treated as legal entities and board members are not liable for most organizational debts.

For profits have much more leeway on how they spend money. Profits either may be distributed to owners or reinvested in the business. Companies may compensate employees well with varied monetary incentives and benefit packages.

Sources of Revenue

Nonprofits obtain income and in-kind donations from donors, foundations, corporations, and government entities. Nonprofits may raise funds through sales of products or fees for services as long as they comply with federal restrictions on such activities.

For-profit companies rely on payment for products and services, investments by owners or investors, and credit arrangements with lenders and suppliers to finance operations.

Accountability and Transparency

Nonprofits are accountable to the public and must file public annual reports with state and federal authorities. For-profits file confidential returns.

Taxes

Nonprofit organizations can apply for income tax exemption under section 501(c)(3) of the tax code. Donations to such organizations may be tax deductible to the donor. Additionally, tax-exempt organizations are exempt from paying sales taxes under state laws. Some types of nonprofits receive property tax exemptions in Texas. Small businesses usually are classified as sole proprietorships, partnerships, or LLCs. Consequently, income is taxable. In Texas, corporations are subject to a state franchise tax. In a sole proprietorship or partnership, founders are personally liable for business debts. Both types of entities must file income reports annually.

Activities

Nonprofits are prohibited from engaging in partisan political activity and are limited in the amount of lobbying efforts. For profit company owners can contribute to political campaigns and lobby as heavily as they wish. Zoning laws may restrict where a for-profit company can operate.

Advantages of a Nonprofit

The primary advantage of a nonprofit corporation is exemption from paying income taxes and other taxes. Nonprofits receive discounted postal rates and may receive other discounts and preferential treatment.

Disadvantages of a Nonprofit

- Nonprofits are not owned by any person, not even by the founders.
- Paperwork and public disclosure-nonprofits are highly regulated, and must file many reports and are subject to public disclosure requirements.

Questions to Ask

- Why do you want to start this endeavor? Do you need a business to make money for you or do you want to give away services to make the world a better place?
- Will the revenue you generate exceed expenses? Is there a reasonable chance that the business will be able to repay your efforts and capital investments in a few years?
- Where will the start-up capital come from?
  Note: Money does not fall from trees for start- up nonprofit organizations and foundations are reluctant to fund organizations without an established track record.
- Do you want to be in control of the endeavor?
  Note: Nonprofits are managed by a board - management is replaceable.

Comparison: Features of For- Profit and Nonprofit Entities	
For-Profit	**Nonprofit**
Owned and controlled by owners	Owned by public
Earns money for owners	Serves the public
Net Income distributed to owners	Net income retained to support mission
Broad leeway on use of funds	Restrictions for charitable purposes
Usually not exempt for state, federal, local taxes	Usually tax exempt
Money invested not deductible	Money donated can be deductible to donor
Managed by owners	Managed by board
Accountable to owners and investors	Accountable to public and funders
Financial records private	Financial records public
Activities can further any legitimate commercial purpose	Limited activities
Broad political participation	No participation in political campaigns; restricted lobbying
No limits on executive compensation	Executive compensation limited
No preferential treatment	May receive preferential discounts

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