



What Do We Mean When We Say “Nonprofit”?

Terminology obscures distinctions that are critical to understanding the rules that apply to organizations

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We often start our lectures by quizzing the participants on their understanding of “nonprofits.”

By show of hands, how many think the following organizations are nonprofits?

The Bill Gates Foundation; your church, synagogue or mosque; the local United Way; the local community foundation; a major local university such as Harvard; a local social service organization; the Sierra Club; the local private golf club; the National Football league; the New York Stock Exchange.

A whole lot of people do not raise their hands very often. The hands particularly start to drop after the United Way or the community foundation. Yet all of these organizations are nonprofits except the New York Stock Exchange. And even the New York Stock Exchange was a nonprofit until 2006.

We all think we know what we mean when we say “nonprofit,” but the key to understanding nonprofits is to understand that there are many different types of nonprofits. Different rules apply depending upon the type of organization. An understanding of the difference is critical to understanding the world of nonprofit organizations.

Nonprofit

“Nonprofit is a concept of state law, which means that an organization may not pay dividends or otherwise pass any surplus revenue, or “profits,” from the enterprise on to shareholders, members or other individuals. Although a nonprofit may pay reasonable compensation for services actually rendered to it, in general, any surplus generated by the organization must stay within the organization and be used for its stated purposes.

(New York Attorney General Eliot Spitzer’s lawsuit against Richard Grasso, former President of the New York Stock Exchange, was based on the provision of the New York Not-for-Profit Corporation Law, which, like most nonprofit corporation laws, permits payment of reasonable compensation only. There is no corresponding limitation in the business corporation law. ([See Ready Reference Page: “Spitzer Challenges Grasso Salary as ‘Objectively Unreasonable’.”](#))

A nonprofit corporation is not “owned” by anyone. It may be controlled by individuals or other entities, but those who control the nonprofit do not have an ownership interest in the organization. ([See Ready Reference Page: “The Key Question: Whose Organization Is It?”](#))

Tax-Exempt

When we say “nonprofit” we are usually thinking of an organization that is exempt from taxation. Most, but not all, nonprofit organizations are exempt from paying *federal* income tax on their earnings.

Section 501(c) of the Tax Code now spells out 29 separate categories of exempt organizations. These categories include:

Section 501(c)(2) title holding companies ([See Ready Reference Page: “Title Holding Companies Have Limited Uses.”](#)); Section 501(c)(4) social welfare and advocacy organizations, like the Sierra Club or the new organizations set up to participate in political campaigns; Section 501(c)(5) agricultural or labor organizations; Section 501(c)(6) business leagues, professional and trade associations, like the National Football League; Section 501(c)(7) social clubs; Section 501(c)(8) and (10) fraternal organizations; cemetery organizations ((c)(13)); veterans organizations ((c)(19)) and so on down to (c)(29).

Charities

The largest category, and the one most people usually think of when they think of “nonprofit” or “tax-exempt,” is Section 501(c)(3) “charitable” organizations. Virtually all charities are nonprofits; but not all nonprofits are charities.

Under the Tax Code definition, a Section 501(c)(3) charitable organization is one which is “organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment) or for the prevention of cruelty to children or animals.”

In addition, no part of the net earnings may inure to the benefit of any private shareholder or individual, no substantial part of the activities may consist of carrying on propaganda, or otherwise attempting, to influence legislation, (“lobbying”), and the organization may not participate in any political campaign for or against any candidate for public office (“electioneering”). (See Ready Reference Pages on [Requirements for Federal Tax Exemption](#), and on [Lobbying and Electioneering](#).)

When the U.S. Supreme Court decided in the *Citizens United* case in 2010 that corporations could spend unlimited amounts on “uncoordinated” political campaign advertising, many existing and newly created 501(c)(4) advocacy groups and 501(c)(6) trade associations significantly increased their electioneering activity, as they are permitted to do under the law. Unfortunately, in much of the media discussion of the expenditures, the media referred to spending by “nonprofits,” without distinguishing between those allowed to participate in elections and charities that are not so permitted. While the media was not wrong in calling these organizations nonprofits, the use of the term was hugely confusing because many people equate “nonprofit” with “charitable” and charities cannot participate in election campaigns.

The other critical distinguishing feature of charities, as opposed to almost all other types of federally exempt organizations, is that individuals and corporations may make charitable contributions to charitable organizations and claim a charitable contribution deduction on their own federal income tax returns.

Public charities and private foundations

Section 501(c)(3) charities are further subdivided under Section 509(a) of the Tax code between “public charities” which receive broad public support and “private foundations” which receive the great bulk of their income from a very limited number of contributors and investment income. All charities are deemed to be private foundations unless they show the Internal Revenue Service that they qualify as public charities. ([See Ready Reference Page: “Calculating Public Support.”](#))

Section 509(a)(1) describes publicly supported organizations such as churches, hospitals and schools, which are considered publicly supported by virtue of what they do, and also organizations that receive a specified percentage of their revenue from a broad range of contributions such as the United Way, or a community foundation.

Section 509(a)(2) describes those that are deemed publicly supported because they receive a broad range of public support from contributions and fees for service, such as many social service organizations or a nursing home.

Section 509(a)(3) describes those organizations that are deemed publicly supported because they are “operated, supervised or controlled by or in connection with” a publicly supported charity or governmental unit. ([See Ready Reference Page: “Supporting Organizations Are Public Charities.”](#))

Charities that don’t meet the criteria of Section 509(a) are considered private foundations. Like the Gates Foundation, essentially all of their income has come from a single or limited number of individuals, families or corporations and income on their investments. Private foundations are subject to more stringent regulation. ([See Ready Reference Pages on Private Foundations.](#))

Nonexempt nonprofits

Although rare, there are nonprofit organizations that are not tax-exempt, like the New York Stock Exchange immediately before it converted to a for-profit so that it could sell stock to provide an ownership interest to investors. A “nonprofit” organization partakes in some of the “halo effect” of the term, even though most people do not understand that the term is not completely descriptive.

Some state nonprofit corporation laws make distinctions between charitable, mutual benefit, religious and other types of nonprofit corporations, and apply different rules for each, but many nonprofit corporation laws have only a single classification that includes all nonprofits.

State tax exemption

State tax exemption in most states is an entirely separate matter. Although most are likely to be exempt from state corporate income taxes, if any, many states have separate criteria, often more stringent than the federal 501(c)(3) criteria, for real estate or state sales tax exemption.

If you can’t identify the category in which a nonprofit fits, you can’t know the rules by which it is regulated.

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