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NONPROFIT ORGANIZATIONS: LEGAL CONSIDERATIONS

*Prepared for Community Legal Resources by
Catherine Brainerd, Sarah E. Heineman, Julie A. Karkosak, and
Robert Rodemeyer of Dykema Gossett PLLC*

Nonprofit corporations are formed for the purpose of serving the public or for a purpose other than the pursuit or accumulation of profits. Any distribution of assets, income, or profits must conform with the purposes of the corporation. Many nonprofit organizations enjoy tax-exempt status, as governed by Section 501(c)(3) of the Internal Revenue Code. To be tax-exempt, an organization must be organized and operated exclusively for one or more of the purposes set forth in IRC Section 501(c)(3). The exempt purposes set forth in IRC Section 501(c)(3) include charitable, educational, religious, literary, or scientific purposes.

While the IRC governs the tax status of these organizations, their formation and operations are regulated by state statutes. In Michigan, the applicable statute is the Nonprofit Corporation Act, M.C.L.A. 450.21.

A. Benefits for Non-Profit Organizations and Their Donors

Nonprofit corporations realize a variety of benefits that for-profit corporations do not. The desire for these particular benefits often weighs heavily in the decision of whether or not an entity chooses to incorporate as a nonprofit. However, the benefits must be analyzed concurrently with the applicable limitations imposed on nonprofits as a consequence of incorporation. Often, the benefits outweigh the drawbacks and incorporation is the right choice. In circumstances where that is not the case, there are other options for the organization, including identifying and partnering up with an existing nonprofit corporation or receiving funds through fiscal sponsorship.

1. Benefits to the Organization

a. Tax Exemptions

Many nonprofit groups are eligible to seek exemption from federal and state income taxes. The most common federal tax exemption comes from IRC Section 501(c)(3), which is why nonprofits are often referred to as 501(c)(3) corporations. If the nonprofit obtains tax-

Community Legal Resources
220 Bagley · Suite 900 · Detroit · Michigan · 48226-1498
Phone: 313/964-4130 · Fax: 313/964-1192
www.clronline.org

exempt status it is free from paying all income taxes on income from activities related to its nonprofit purpose. In addition to exemption from income taxes, nonprofits are usually exempt from paying property taxes on certain real estate and other property. The property tax exemption is known as the “welfare exemption,” and the county’s assessor’s office can provide more information.

b. Receiving Public Funds

As a general rule, nonprofit status is a requirement for obtaining funds from government agencies and private foundations. Additionally, in order to avoid endangering their own nonprofit status, many organizations are required by law to donate a certain percentage of their funds to nonprofit organizations. Also, many exemptions exist for property transferred at death to a nonprofit organization.

c. Limited Liability for Members and Directors

Just as with for-profit corporations, directors, trustees, and officers of nonprofit organizations are generally given the same limited liability status. Creditors may only reach as far as the nonprofit corporation’s assets to satisfy corporate debts, rather than the personal assets of the individuals involved with the corporation. Furthermore, those directors, trustees, and officers will be protected in case the organization is drawn into a lawsuit. Incorporating can support the individuals in defending the lawsuit and protecting them from personal liability. There are exceptions to the limited liability rule, however. If a director made a personal guarantee in order to gain an extension of credit for the corporation, if an officer fails to report or pay certain taxes, or if a corporate officer or director violates a statutory duty, that individual could be found personally liable.

d. Separate and Perpetual Existence

A nonprofit corporation, just like a for-profit one, has the organizational structure to outlive all of its founders. The corporation has the ability to act as an individual by entering into contracts, incurring debt, and owning real property.

e. Employee Benefits

Nonprofit corporations may choose to operate entirely by volunteers, or may elect to employ and compensate a staff. Reasonable salaries are a permissible expenditure, as long as the payment is compensation for work related to the furtherance of the nonprofit’s goals and objectives. Such employees can be eligible for fringe benefits that are not available to self-employed people, such as sick pay, group life insurance, and corporate pension plans.

f. No Prohibition on Making A Profit

Nonprofit corporations, by definition, do not exist to make money, but rather to fulfill their stated purposes. However, as long as a nonprofit corporation is organized and operated for a recognized nonprofit purpose and has secured the proper tax exemptions, the organization may

take in more money than it spends to conduct its activities—effectively making a profit. It is important to note the difference between the profit gained from related and unrelated activities.

As long as a nonprofit's activities are related to its purpose, any profit made from those activities is not taxable. The organization may use this income to cover its own operating expenses, such as paying salaries for certain officers, or for the benefit of its stated purpose. This income may *not* be distributed to the nonprofit's officers or members in the form of profit sharing.

At times, nonprofit organizations may generate income through activities that are not related to its nonprofit purpose. This is often perfectly acceptable. However, corporate income taxes must be paid on this income, under both federal and state corporate tax rules. Though such income is often considered acceptable, once it reaches a level that is determined to be "excessive," the IRS may decide to reevaluate the organization's 501(c)(3) tax-exempt status. To avoid this, the nonprofit should never let its unrelated business activities rise to the level of a regular commercial business or take over the initial, nonprofit purpose of the organization. If the unrelated activity becomes remotely substantial, the nonprofit must set up a separate corporation to engage in that activity, or risk losing its tax exempt status.

g. Miscellaneous Advantages

There are other minor advantages available for nonprofit organizations that are often overlooked. For example, nonprofit corporations under 501(c)(3) receive lower postal rates on bulk mail. Also, many organizations offer discounted advertising rates to nonprofit corporations. Many internet service providers also offer lower rates. Some national chains, such as Costco, offer lower membership rates. In addition, nonprofit corporate employees may qualify for job-training and other work-study programs subsidized by the federal government.

2. Benefits to Donors

If a nonprofit is recognized as a 501(c)(3), people and organizations that wish to contribute can deduct their gifts to the organization on their federal and state income tax returns.

B. Limitations on Non-Profit Organizations

Some individuals and organizations which are considering whether or not to incorporate as a nonprofit may find the complex paperwork to be a disadvantage. Nonprofit organizations are typically run quite similar to for-profit corporations and must deal with many of the same requirements. Articles of Incorporation must be prepared and filed with the appropriate state entity. Also, bylaws must be drafted and minutes maintained. Additionally, forms must be completed and filed for tax exemption status. Only after a corporation is approved by the IRS as a tax exempt organization can it be certain that it is in fact a tax exempt corporation.

In providing corporations tax exempt status, Congress imposed specific requirements and limitations on their activities. These rules are strictly enforced by the IRS and failure to comply

could cost the organization its tax exempt status, grants and funding, and even its limited liability status.

1. No Contribution to Political Campaigns

Nonprofit corporations with 501(c)(3) tax exempt status are prohibited from participating in political campaigns or donating money to them. The nonprofit entity may not back any particular candidate and must remain nonpartisan. This issue has been thrust to the forefront as nonprofits have found themselves caught up in the growing debate over new campaign finance rules. The proposed rules resulted from the passage of the Bipartisan Campaign Reform Act, also known as the McCain-Feingold Act, which bans “soft money” contributions to political parties, rather than to individual candidates. Currently, the Act applies to organizations incorporated under IRC Section 527. If this extends to organizations incorporated under Section 501(c), some say that this will inhibit the efforts of nonprofit organizations from voicing their opinion on general issues of concern and fundraising efforts.

2. Only Limited Lobbying Activities

Along the same lines as above, nonprofit organizations that influence legislation to any substantial degree may face the loss of their nonprofit status. Fortunately, the IRS does not completely forbid lobbying, but simply sets a limit on the money that can be spent on political activities. However, this may also change as the issue of campaign finance rules continues to develop.

3. No Distribution of Profits to Members, Officers, or Directors

Unlike for-profit companies, nonprofits may not be organized to financially benefit its members. However, this does not include reasonable salaries or expense reimbursements.

4. Profit from Unrelated Activities Subject to Taxation

Please see discussion of issue in the profit component of the benefits section above for more information.

5. Upon Dissolution, Assets Must Be Distributed to Another Tax-Exempt Group

Tax-exempt groups cannot be owned, therefore can never be sold. When the officers or directors decide to disband the organization, any assets belonging to it must be distributed to another nonprofit entity. Furthermore, once assets become the property of the nonprofit, they cannot later be distributed to a member or director.

C. Summary of Considerations in Forming a Non-Profit Organization

Incorporating into a nonprofit organization offers many advantages. Nonprofit corporations are able to enjoy many of the same benefits as for-profit corporations, including limited liability for corporate officers and a separate and perpetual existence, capable of entering

into contracts or buying property. However, nonprofit organizations are also eligible for additional benefits, including exemption from property taxes and income taxes from any funds earned that are related to its nonprofit purpose. In fact, its very status under 501(c)(3) often makes funding possible.

Nonetheless, with the added benefits come additional limitations. Nonprofit organizations may not support political candidates or become involved in any legislative lobbying efforts to a substantive degree. Also, though the corporation may earn a profit, such financial gains may not be distributed to any officers or members. And as a tax-exempt group cannot be owned, it cannot be sold. Therefore, upon dissolution of a nonprofit, all assets must be given to another tax-exempt group.

When determining whether or not it is appropriate to incorporate as a nonprofit, it is vital to consider the benefits, disadvantages, and repercussions of that choice. Though nonprofit organizations are formed with regularity and enjoy overwhelming success, such formation is not the right choice for everyone. If the benefits of incorporation seem to outweigh the limitations, it is likely that becoming a 501(c)(3) nonprofit corporation is the right choice.

ADDITIONAL SOURCES OF INFORMATION ON NON-PROFIT ORGANIZATIONS

Michigan Nonprofit Association—www.mnaonline.org or call (517) 492-2400

For a *Getting Started* Packet and Seminar Information

- Volunteer Accounting Services Team—www.accountingaidsociety.org or call (313) 647-9620

Nonprofit Seminar

- State of Michigan, Department of Consumer and Industry Services, Corporate Division (for information on a Nonprofit Seminar)—
www.cis.state.mi.us/bcs/corp.home.htm or call (517) 241-6470

Forms and Assistance

- Internal Revenue Service—www.irs.gov or call 800-829-3676
- State of Michigan Corporation Division of the State Department of Consumer and Industry Services—www.cis.state.mi.us/bcs/corp/home.htm or call (517) 241-6470.
- State of Michigan's Attorney General, Charitable Trust Division—
www.ag.state.mi.us/charities.htm or call (517) 373-1152
- Michigan Department of Treasury—call (517) 636-4660

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