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Nonprofits Founded by Business Owners

May the owner of a business that provides educational or social services set up an affiliated nonprofit to tap into charitable grants and donations?

Even if the business owner has good intentions, the IRS may reject the nonprofit's application for recognition of tax-exempt status under Section 501(c)(3). Or the IRS may revoke the nonprofit's tax-exempt status down the road. Here's why.

Some Basic Rules

Organized and Operating Exclusively for Tax-Exempt Purposes. Nonprofits that are tax-exempt under Section 501(c)(3) of the Internal Revenue Code must be organized and operated exclusively for tax-exempt purposes. "Exclusively" means only an insubstantial amount of their activities can be for other purposes.

Public Charity or Private Foundation All Section 501(c)(3) organizations are classified as either public charities or private foundations. Public charities include publicly supported organizations that receive contributions from a broad group of sources. Public charities also include schools, hospitals, churches and certain organizations affiliated with such organizations.

Private foundations, although tax-exempt under Section 501(c)(3) and entitled to receive deductible contributions within certain limitations, are subject to rigid constraints on transactions with "disqualified persons" as defined by the IRS. Subject to a few exceptions, any sale or exchange of property between a private foundation and a disqualified person, and any payment by a private foundation to a disqualified person, is prohibited. Disqualified persons include the foundation's founder, substantial contributors, board members and their family members. A charity classified as a private foundation cannot generally undertake any transaction with an affiliated for-profit entity without incurring significant penalties.

Private Benefit Rule. Nonprofits that are tax-exempt under Section 501(c)(3) and are public charities are also subject to limitations and may not use their assets or activities to benefit any private individual, business or non-charitable entity. This is known as the "private benefit" rule. A private individual is someone who profits personally, rather than receiving benefits as a member of the charitable class (the people intended to be assisted by the nonprofit's charitable activities). Reasonable compensation of individuals for services to the nonprofit is permitted, subject to the nonprofit's conflict of interest policy (and subject to the private foundation rules, if the nonprofit is a private foundation).

No Private Inurement. In addition, the IRS prohibits using the net earnings of a nonprofit that is tax-exempt under Section 501(c)(3) to benefit any person who has a "personal and private interest in the activities of the organization." This includes directors, officers, key employees and key independent contractors, and any donor who has substantial influence on the organization. Again, reasonable compensation of individuals for services to the nonprofit is permitted, subject to the nonprofit's conflict of interest policy. However, the nonprofit should be cautious; the consequences of violating this rule against "private inurement" can be severe, for the organization, its managers and the individual receiving the benefit.

The fundamental principle of these rules is to prohibit unjust enrichment, including channeling charitable funds and benefits to a for-profit business. If a nonprofit organization and a for-profit business have the same or overlapping founders, directors, officers or employees, there's an increased risk that the nonprofit may violate IRS rules and regulations.

Examples

- A business owner would like to set up a nonprofit that is tax-exempt under Section 501(c)(3) to raise money for "scholarships" (grants) to individuals who are unable to afford services offered by the founder's for-profit business. (For this example, assume that the individuals qualify as members of a charitable class, as defined by the IRS.)

- A business owner would like to set up a nonprofit that is tax-exempt under Section 501(c)(3) to raise money for and offer educational, community-building and advocacy programs. The nonprofit will refer people to the founder's for-profit business for services. Or the nonprofit will purchase goods or services from the for-profit business.

- A business owner would like to set up a nonprofit that is tax-exempt under Section 501(c)(3), which will provide services similar to those provided by the founder's for-profit business.

Problem

The IRS may decide that the nonprofit is using its charitable revenue, assets or activities to channel customers or funds to the founder's for-profit business. Even if payments received by a for-profit business are reasonable, the IRS may find that there is an impermissible relationship if the for-profit business benefits substantially from the operation of the nonprofit.

In the last example above, the IRS may decide that the nonprofit and the for-profit are too interrelated to be considered separate entities, or that their similarities will result in the founder's for-profit business benefiting from the nonprofit's activities.

However, sometimes a nonprofit can carefully structure its relationship with a for-profit business so that it does not violate the IRS rules. This must be analyzed on a case-by-case basis, with the guidance of a nonprofit tax attorney or nonprofit tax accountant who is an expert in this area.

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Nonprofits that are (or would like to be) tax-exempt under Section 501(c)(3) should consult a nonprofit tax attorney or accountant for guidance on how IRS rules and regulations apply to their situation.