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Nonprofit Topic:

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.

Private Benefit Rule. Public charities that are tax-exempt under Section 501(c)(3) must engage primarily in activities that accomplish their exempt purposes and must serve public interests, not private ones. Benefits to people or entities, other than the "charitable class" eligible to be assisted by the nonprofit's tax-exempt activities, must be incidental. Reasonable compensation of individuals for services to the nonprofit is permitted, subject to the organization's conflict of interest policy. However, other market-rate payments to individuals or entities outside the organization's charitable class may not be allowed—if they are more than an incidental part of the nonprofit's activities. Whether the private benefit is incidental depends on how the tax law applies to a particular nonprofit's purposes and activities. For guidance, the nonprofit should consult with an expert in the law of tax-exempt organizations.

No Private Inurement. Tax law also prohibits public charities that are tax-exempt under Section 501(c)(3) from using their net earnings to benefit any person who has a "personal and private interest in the activities of the organization." This includes anyone who has significant influence over the organization, such as founders, directors, officers, members, key employees or independent contractors and substantial donors. The benefit to the insider could be direct or indirect, such as benefits to a founder's family member or an entity affiliated with a founder or their family member. Again, reasonable compensation of individuals for services to the nonprofit is permitted, subject to the organization's conflict of interest policy. However, nonprofits should be cautious; even a small amount of private inurement is impermissible, and

the consequences of violating the rule against private inurement can be severe, for the organization, its managers and the individual receiving the benefit.

Excess Benefit Transactions. Certain tax-exempt organizations (including Section 501(c)(3) public charities) can trigger penalty taxes if they directly or indirectly give an economic benefit to a “disqualified person” that exceeds what the disqualified person provides to the organization in return. Disqualified persons include anyone who is or was (during the five years before the transaction) in a position to exercise substantial influence over the organization, plus their family members and entities they control. The economic benefit received by the disqualified person may include unreasonable compensation for services, excess payments in exchange for assets, rentals, loans, or rights to use assets of the organization. The penalty tax is imposed on the disqualified person and potentially also on the organization’s managers. The IRS may also revoke the organization’s tax-exempt status.

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, or if the nonprofit is controlled by a small group of related people (or by a for-profit company), there is 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 as a public charity 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 as a public charity 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 as a public charity 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, or if there is private inurement.

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.

Similar considerations apply to nonprofits offering services that are often provided by for-profit businesses—even if the nonprofit is not directly related to a for-profit business. For example, health clubs may be tax-exempt nonprofits or for-profit businesses. There is a considerable amount of tax law analyzing the facts and circumstances that make a health club eligible for tax-exempt status, and those that disqualify it.

Sometimes a nonprofit can carefully structure its activities, and its relationships with for-profit businesses, 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.

What if the Nonprofit is Not a Public Charity--or Loses its Public Charity Classification?

Classification. 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 affiliated organizations. Private foundations tend to be funded by a limited number of sources and often operate only to make grants to other charities.

Private Foundation. If a nonprofit is classified as a private foundation in its IRS determination letter, or if it loses its status as a public charity and is deemed to be a private foundation---frequently, because it does not meet the IRS's public support test---it will still be tax-exempt under Section 501(c)(3). However, the organization will be subject to various rules that only apply to private foundations, including limitations on deductible contributions and rigid constraints on transactions with "disqualified persons" (as defined by the IRS) and affiliated for-profit entities.

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 engage in any transaction with an affiliated for-profit entity without incurring significant penalties.

Governance and Compensation

Independent Board of Directors and Conflict of Interest Policy

It's especially important for the new nonprofit's Board of Directors to have a majority of independent directors and to adopt a conflict of interest policy. Governing a nonprofit that has an affiliation with a for-profit entity raises potential conflicts of interest, questions about founder compensation and other issues that could compromise the nonprofit's good governance, operations and legal compliance.

Founder Compensation

Although a nonprofit is permitted to pay individuals reasonable compensation for services (subject to the nonprofit's conflict of interest policy), the founder's compensation must not violate the private benefit rule or the private inurement rule or trigger the excess benefit tax. The IRS recommends a three-step process for a nonprofit to determine compensation.

<https://www.irs.gov/charities-non-profits/charitable-organizations/rebuttable-presumption-intermediate-sanctions>

Broadly speaking, the steps are (1) prior approval of compensation by independent directors who do not have a conflict of interest concerning the compensation, (2) obtaining and relying on appropriate compensation comparability data and (3) concurrent documentation by the board of the basis for the decision.

The National Council of Nonprofits provides information on this topic.

<https://www.councilofnonprofits.org/running-nonprofit/governance-leadership/executive-compensation>

Disclaimer: This information is provided for educational purposes only. It is not intended or offered as legal advice. Please consult an attorney for the latest and most accurate information, and advice on how it may apply to your organization.