



Structure of Nonprofit Organizations

CORPORATIONS

One of the distinguishing features of our legal and financial systems is that they have found a way to make something that no one can see or touch seem real—and therefore, it has become *real*. The high point of this accomplishment is that perfectly intelligent, normal people can find themselves debating the virtues of the behavior of this thing and even changing their own behaviors and choices because of its existence.

We are talking, of course, about the corporation. Even the word itself sounds substantial, and when various names or other identifiers get put in front of it, we accept the results easily. But the idea of a corporation is nothing more than a construct that gains substance and credibility in financial matters largely because we need it to do so. Our acceptance of the metaphor of a corporate *structure* is tangible evidence that we human beings yearn for predictability and consistency even when the entity itself exists only in our minds and in the ways that a corporate structure is said to *behave*.

We say all this because whatever corporate structures lack in tangible qualities they more than make up for via their widely accepted ways of indicating financial boundaries. As you will see later in this book, those boundaries can take on the nearly concrete feel of something that can seem to be virtually a physical presence.

The highest level of nonprofit management is the corporation that “owns” or runs the programs. The corporation is a statutory entity

established by the legally sanctioned actions of one or more individuals. As a legally approved entity separate from its constituent individuals, the corporation has its own continuing existence. In legal theory, corporations are treated as distinct entities like individual people, and corporations have their own collection of responsibilities, liabilities, and powers.

Why a corporation? The answer is disarmingly simple: because it's easier for the rest of us. Corporations can be mentioned in the same legal breath as the individuals who use their services, work in them, or simply exist in the same state with them. All are on the same legal footing, in that respect. The complicated and narrower answer to the question has to do with a variety of practical considerations. For instance, revenue source regulations and political realities often nudge nonprofits in the direction of a specific type of organizational structure. Programs such as battered women's shelters almost of necessity start out as single-service corporations, while older and more established groups may have developed a multicorporate structure.

There are also liability laws to consider when operating different types of businesses. Nonprofit public charities traditionally have been granted generous protection from state liability laws, although that tendency is beginning to change. It's a tradition growing out of English common law that has been codified in many places around the country. Often there will be either an explicit limitation on suits or a prohibition altogether on the grounds that entities funded by the public at large ought not to be siphoning resources into private hands via lawsuits. Liability considerations alone are not normally strong enough to determine a corporate structure, but the more favorable liability climate for public charities is clear.

Like most for-profit businesses, nonprofit organizations must have a legally acceptable structure within which to operate. Nonprofit public charities are officially considered 501(c)(3) corporations. There are literally dozens of other structural choices in the IRS list of tax-exempt entity types, but this one is easily the best known. The official IRS list of these choices is reproduced in Exhibit 1.1 from IRS Publication 577.

This bloodless list of unsentimental choices obscures a central point. Corporate structures in the nonprofit world are chosen for many reasons, the primary ones being risk management, tax treatment, and the best available corporate fit for carrying out missions. The same kind of reasoning

about structural choice takes place in for-profit entities. With such a large number of potential structural options, entrepreneurs—in the nonprofit sector or outside of it—would do well to mimic the guiding principle of good architecture: *form follows function*. Put simply, be as clear as one can possibly be in determining what one wishes to accomplish *and then* give some serious thought to the best structural choice available.

This area of structural choice for public-serving entities has seen unprecedented innovation recently. One of the most intriguing developments in the nonprofit sector has been the rise of alternative structural choices, such as low-profit limited liability companies (L3Cs) and benefit corporations (more about these and other choices will follow).

DROPPING OUT OF SCHOOL

The community center prided itself on being able to identify community needs and respond to them effectively over time. Unfortunately, their grand, old 175,000-square-foot building had already chewed up substantial funding just to keep it running. They achieved their first operating surplus in years, but it was a tissue-thin \$7,900 on a budget of \$10 million. Projections for next year contemplated more red ink.

The most prominent program in their building was their Montessori school, which occupied only about 7 percent of their total space but represented half of their total employees. Moreover, it was running a regular six-figure deficit. As part of a strategic positioning process, the question arose: *Why are we doing this?*

There was not an obvious answer. When a financial commitment of this size does not have a ready answer to this simple question, it is usually time for some rethinking, which is what the center did. As a result, the school was spun off as its own nonprofit public charity, with parents and teachers taking over the management. The happy ending is that the school now rents its space from the community center and is a steady source of earned income.

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Ultimately, corporate structures are simply a way to organize programs and services in logical ways to achieve maximum results. What the community center realized was that a Montessori school, while important to the community, was too much of a mission stretch for them. Recasting the legal structures allowed the center to focus on the programs and services it was good at, while turning a management diversion into a source of revenue.

PROGRAMS

Programs are the most visible and best understood aspect of the nonprofit form of business organization and its chief means of carrying out its mission. Also called services, projects, clinics, divisions, departments, floors, or any one of a thousand other names, programs are the activities of the nonprofit organization.

Coming up with a fair and workable definition of a program is difficult. Here's an attempt: A program is a coherently packaged group of activities, usually associated with one or more specific locations, designed to accomplish a stated result.

Nonprofit organizations run all kinds of programs and often more than one. Day care centers offer infant care programs, environmental groups operate recycling systems, museums run art appreciation courses, and so forth. The two keys to understanding programs are that they generally have some coherent internal structure, and they appear as distinct choices to potential users.

In most nonprofit organizations, programs are like little businesses, with a structure reinforced by nonprofit accounting rules and with immense if largely unnoticed consequences for everything from compensation to organizational effectiveness. They represent a delegation of responsibility from the CEO, and so they are the engines of mission. It is at the program level that the organization's goals are accomplished or not; therefore, those in charge of programs carry heavy moral pressure to get the job done.

Notice the use of the word "moral" in the preceding sentence. Typically, the motivations of those who run nonprofit organizations are different

from those who do the same thing in the for-profit world, and the motivations of program managers everywhere are often different still from their bosses. We'll explore some of those differing interests later. For the moment, we'll use the program as the smallest management unit of the nonprofit corporation.

The Role of the Internal Revenue Service

If programs sometimes seem fuzzily defined, there is no such problem with corporate structure. Unlike other forms of business organization, a corporation does not exist until certain governmental authorities say it exists. For nonprofit corporations, the lead voice in the chorus is the Internal Revenue Service (IRS). In matters having to do with nonprofit corporations, it is the IRS that giveth and the IRS that taketh away.

Corporations are organized according to the laws of individual states. Ordinarily, starting a corporation is as easy as filing the required paperwork and paying the necessary fees; in fact, that is how all corporations must start. But government at all levels reserves the right to tax the profits of a business. In order to get the government to waive its right to tax—to allow a corporation to be *tax exempt*—a would-be nonprofit corporation must show that it has been created and will be operated with certain purposes in mind. It must do so according to pre-established guidelines spelled out in the code. Then, it must wait for the IRS's decision on the application.

IRS acceptance of exempt status is the turning point. After this step, state government often must have its say about the organization's acceptability as a tax-exempt entity. Normally, state government is willing to follow the IRS's lead, so once the IRS has weighed in, it's usually pro forma thereafter.

In effect, the IRS considers all nonprofits to be taxable entities until they prove otherwise. The major thing that distinguishes a nonprofit from a for-profit corporation is that most nonprofits (including all charities) are not allowed to have shareholders with whom to share profits. Note that this is not a prohibition against profits, just against having shareholders with whom to share them. This is the reason why it is often said that the profits of a nonprofit are kept within the corporation—salaries, benefits, and perks notwithstanding.

The first permanent federal income tax was enacted in 1913 but affected less than one-half of 1 percent of the population. Congress expanded the tax base in 1917, when it also initiated a deduction for charitable contributions.

HYBRID CORPORATIONS

In recent years, there has been growing interest in what are sometimes known as “hybrid” corporations. These entities combine the explicit profit making and ease of capital formation characteristic of for-profit corporations with the social responsibility of nonprofits. Social enterprise practitioners are particularly interested in hybrid corporations because they often must create a basis for social responsibility in a for-profit or manufacture ways to raise private equity (not donations) through a nonprofit. The compromises they must reach are unsatisfying or impractical, and that is what drives the search for a new form.

There is some precedent for these hybrid corporations, such as in England where the community interest company form was approved in 2004 or in the United States where well-known groups such as Newman’s Own or Ben & Jerry’s Ice Cream were among the first to mold traditional for-profits into social enterprises. Many nonprofits have been experimenting with for-profit-like structures and cultures. The difficulty is that these are one-of-a-kind ventures. Creative legal and financial advisors can often find ways to jerry-rig a structure that mimics a hybrid corporation, but until such options are well defined, well understood, and enshrined in law in all states, hybrid corporations will never really become widely accepted. This is the significance of the L3C form that first gained legal acceptance in 2008. This variation on the traditional limited liability corporation (LLC) is specifically intended to support social enterprise, and so it has become the first genuine prototype in hybrid structure.

An IRS Question: Private Foundation or Not?

Historically, Congress has disliked private foundations, which are a form of charitable organization, probably because of the abuses that occurred when they were first created. In 1969, the U.S. Congress laid the groundwork

for what we now call private foundations. In the process of paying attention to private foundations, however, a curious thing happened. The IRS actually developed a much clearer and better developed sense of what a private foundation is than what a public charity is. Consequently, it essentially regards public charities as nonprofit corporations that are *not* private foundations. This is why the IRS letter granting tax-exempt public charity status says that the applicant is a tax-exempt corporation that is not a private foundation.

The driving force around which the determination of private foundation or public charity status revolves has nothing to do with public mission but rather is usually a product of that old-fashioned determinant, money and its control. Whereas a private foundation derives its initial or ongoing funding from limited private sources, regulators expect the charitable organization to get its funding from the public at large. For many public charities, that hurdle is set at one-third of total revenue, although in a few obscure legal cases that percentage could be lower.

It is not hard to infer the authorities' motivation here. Private foundations' sole source of revenue being a single individual or family gives the founders tremendous control over determining who gets the benefits of the tax-exempt activity. It could also lead to a temptation to abuse that power if not kept in check. By obliging public charities to derive a substantial chunk of their revenue from the public at large, Congress has virtually guaranteed that a public charity's management could never exercise the same degree of control.

Another IRS Question: What Type of Nonprofit?

So far it may seem as though the nonprofit organization's only choice about tax-exempt status is between private foundation and not a private foundation, but the range of choices is much broader than that. In fact, the familiar nonprofit public charity is only one of several possible options under which a nonprofit corporation can operate. In official IRS parlance, nonprofits are organized under Section 501(c) of the code. What all of these types of corporations have in common is that (1) they are exempt from federal and usually state corporate taxes and, in the case of public charities, (2) they are not private foundations. Significantly, only 501(c)(3) corporations—and a few others, under certain circumstances—can offer donors the right to deduct contributions from taxable income. The graph on pages 10 and 11 highlight some of the differences between nonprofit organizations. (See Exhibit 1.1.)

**FORM 990 RETURNS OF 501(C)(3)–(9) ORGANIZATIONS: BALANCE SHEET AND INCOME STATEMENT ITEMS,
BY CODE SECTION, TAX YEAR 2012**

Item	Internal Revenue Code Section						
	501(c)(3) ⁽¹⁾	501(c)(4)	501(c)(5)	501(c)(6)	501(c)(7)	501(c)(8)	501(c)(9)
	(1)	(2)	(3)	(4)	(5)	(6)	(7)
Number of returns	192,915	11,845	10,381	17,899	10,061	4,969	4,899
Total assets	3,266,580,329	111,996,674	34,906,701	72,871,828	25,696,376	135,180,892	213,141,693
Cash—non-interest bearing	83,820,056	5,082,544	2,698,036	5,005,839	1,646,656	517,777	3,588,331
Savings and temporary cash investments	201,196,619	9,730,354	6,783,280	10,978,229	1,838,562	4,948,650	18,419,967
Pledges and grants receivable	75,238,145	408,427	27,613	300,781	5,284	*303	121,190
Accounts receivable	158,558,821	5,465,161	1,077,645	3,850,771	1,383,356	273,729	8,754,600
Receivables from officers, etc.	569,526	152,477	*2,150	13,167	5,160	311	631
Receivables from disqualified persons	264,964	0	2	*338	61	0	42,393
Notes and loans receivables	93,215,763	22,578,601	364,606	1,895,539	176,206	1,756,638	132,505
Inventories for sale or use	18,196,349	182,734	35,070	178,229	291,902	36,596	7,665
Prepaid expenses and deferred charges	24,116,352	902,303	125,073	845,784	221,045	83,131	268,189
Land, buildings, and equipment (net)	940,828,795	11,686,503	5,019,781	6,137,815	18,766,253	2,082,511	502,815
Investments in public securities	792,706,758	29,854,178	13,289,706	33,906,927	629,852	80,377,175	91,055,579

Investments in other securities	589,012,677	9,256,421	4,399,294	5,572,592	162,236	14,109,854	81,854,897
Program-related investments	55,979,762	10,020,360	131,602	1,449,520	58,592	12,490,146	860,995
Intangible assets	12,684,403	205,472	22,216	153,120	101,047	*191,717	0
Other assets	220,191,337	6,471,140	930,629	2,583,176	410,163	18,312,354	7,531,937
Total liabilities	1,302,783,518	54,731,992	7,751,093	41,723,107	8,983,733	120,530,610	24,218,912
Accounts payable and accrued expenses	236,602,980	13,973,352	3,708,398	7,828,097	1,128,140	4,738,534	9,875,891
Grants payable	16,665,660	751,940	115,086	150,494	*2,034	*9,054	50,920
Deferred revenue	71,637,006	4,189,015	312,876	6,016,451	1,125,072	73,017	589,867
Tax-exempt bond liabilities	399,662,984	4,920,088	*38	57,413	*13,722	*25,011	0
Escrow account liability	8,182,000	620,884	110,212	183,679	28,151	9,678	55,629
Payables to officers, directors, etc.	2,690,138	*58,593	*10,086	11,129	39,066	0	315
Secured mortgages and notes payable	187,925,088	11,303,035	925,885	3,363,196	5,187,508	171,600	44,551
Unsecured notes and loans payable	42,983,622	11,896,881	39,446	187,468	402,774	*8,329	44,156
Other liabilities	336,434,038	7,018,204	2,529,065	23,925,179	1,057,267	115,495,388	13,557,584
Total net assets	1,963,796,811	57,264,682	27,155,608	31,148,721	16,712,643	14,650,282	188,922,781
Total revenue	1,726,300,540	93,256,311	23,147,289	41,831,798	12,756,586	18,781,109	138,727,323
Total contributions, gifts and grants	366,842,354	8,393,994	3,217,251	6,454,597	1,317,421	282,009	670,080
Federated campaigns	2,740,782	*2,155	0	*13,011	*3,967	*14,529	0
Membership dues	4,110,987	1,242,578	2,540,174	3,309,355	1,171,768	177,506	*93,530
Fundraising events	7,680,228	51,775	14,849	14,603	17,508	17,830	*42
Related organizations	18,800,463	259,764	88,292	212,120	6,903	23,457	121,957

(continued)

EXHIBIT 1.1 (CONTINUED)

Item	Internal Revenue Code Section						
	501(c)(3) ⁽¹⁾	501(c)(4)	501(c)(5)	501(c)(6)	501(c)(7)	501(c)(8)	501(c)(9)
	(1)	(2)	(3)	(4)	(5)	(6)	(7)
Government grants (contributions)	153,671,682	1,604,458	132,996	1,700,147	*3,489	*5,112	*17,863
All other contributions, gifts, etc.	179,838,212	5,233,263	440,940	1,205,361	113,786	43,574	436,688
Program service revenue	1,246,212,631	80,007,856	17,784,703	31,233,323	8,750,804	13,452,574	129,032,550
Investment income	31,241,692	1,061,786	591,890	1,055,411	37,167	3,482,064	4,556,453
Tax-exempt bond proceeds	147,631	424	0	*1,167	*83	34,915	16,861
Royalties	4,186,098	806,165	239,506	546,788	11,655	4,249	0
Total net rental income	3,512,268	232,982	104,653	53,526	48,339	26,516	257
Net rent—Real estate	3,412,655	230,040	104,794	53,290	42,261	24,190	257
Gross rents	7,252,729	327,536	216,916	197,460	102,976	42,219	11,212
Rental expense	3,840,074	97,496	112,122	144,170	60,715	18,029	10,955
Net rent—Personal property	99,613	*2,942	*-141	*236	6,078	*2,325	0
Gross rents	157,573	*6,488	*654	*575	7,352	*2,843	0
Rental expense	57,960	*3,546	*795	*339	*1,275	518	0
Total net gain from sales of assets	40,488,158	477,742	220,051	656,150	20,966	-18,459	3,369,204
Net gain from sales—Securities	35,891,151	424,414	210,657	578,017	26,123	89,913	3,018,647
Gross sales	707,754,043	15,333,893	10,044,907	13,562,869	184,358	38,844,033	419,964,848

Sales expense	671,862,892	14,909,479	9,834,250	12,984,852	158,234	38,754,121	416,946,202
Net gain from sales—Other assets	4,597,008	53,328	9,394	78,134	-5,157	-108,372	350,558
Gross sales	17,393,188	509,502	239,432	164,857	86,033	82,014	9,114,343
Sales expense	12,796,181	456,174	230,038	86,723	91,190	190,386	8,763,785
Net fundraising income	1,852,634	54,228	7,691	207,413	35,416	36,801	*630
Gross fundraising income	6,072,330	239,274	47,895	499,111	96,831	99,251	*1,643
Fundraising expenses	4,219,695	185,046	40,204	291,698	61,414	62,450	*1,013
Net gaming income	315,555	91,337	*382	*659	30,956	133,818	*65
Gross income from gaming	1,916,538	536,843	*1,970	*945	80,452	537,200	*6,424
Gaming expenses	1,600,983	445,506	*1,589	*286	49,496	403,381	*6,359
Net income from sales of inventory	6,438,373	127,430	17,650	224,743	2,064,237	158,879	-2,266
Gross sales of inventory	15,062,314	507,339	67,421	400,421	3,899,031	522,560	21,515
Cost of goods sold	8,623,941	379,910	49,770	175,678	1,834,794	363,680	23,781
Other revenue	25,063,140	2,002,366	963,511	1,398,022	439,541	1,187,742	1,083,488
Total expenses	1,616,634,043	90,820,244	22,240,863	40,005,484	12,439,523	17,671,338	135,806,288
Program services	1,401,419,364	83,797,836	[2]	[2]	[2]	[2]	[2]
Management and general	197,519,756	6,576,139	[2]	[2]	[2]	[2]	[2]
Fundraising	17,694,923	446,269	[2]	[2]	[2]	[2]	[2]
Excess of revenue over expenses (net)	109,666,497	2,436,067	906,426	1,826,315	317,063	1,109,770	2,921,035

*Estimate should be used with caution because of the small number of sample returns on which it is based.

¹Excludes private foundations, most churches, and certain other types of religious organizations.

²Not required to be reported.

NOTES: Data exclude most organizations with receipts less than \$50,000. Detail may not add to totals because of rounding.

Source: IRS, Statistics of Income Division, Exempt Organizations (Except Private Foundations), July 2015.

LOSS OF TAX-EXEMPT STATUS: THE MONSTER WITHIN

There is a monster loose in nonprofit land. It is a monster few have seen but many can describe, summoned up from nightmares to give body to commonly held, nameless fears. It has the power to terrorize whole boards of directors, senior staffs, attorneys, accountants, managers, and donors. It is the monster called “loss of tax-exempt status.”

Like most monsters, this one’s power comes not from what it does directly but from its ability to govern our thoughts and shape our actions in anticipation of encountering it. And it is in the latter dynamic that the uncritical mind is most vulnerable to the advice of those who would pretend to have glimpsed the beast.

Let us make the monster slink away into the night, discouraged by reality. According to the IRS, in many years, the total number of those organizations that lost their tax-exempt status is around 100. In 2007, the IRS revoked 116 tax-exempt statuses.

If this surprises you, it might be well to remember that the business of managing the tax responsibilities of tax-exempt organizations is, at least at their initialization, largely a matter of trust. The IRS trusts that organizations that say they are organized to benefit the public good will do just that, and because the only return that they file (Form 990) doesn’t determine the amount of money the government gets paid in taxes, there is little reason to systematically review it the way personal and for-profit corporate returns are handled. To put it another way, there’s little payoff for the IRS to go looking for trouble in this sector.

Revocation Not Typical of Public Charities

When trouble finds the IRS and results in these yearly hundred or so tax-exempt status revocations, it tends to fall disproportionately on groups that are not public charities. These organizations are social clubs, trade associations, fraternal organizations, and the like that enjoy tax-exempt status but are not considered public charities in the same mode as the more familiar hospitals and universities.

By far, the biggest reason for exempt-status revocation is that the corporations violated the prohibition against private inurement, meaning that they used their tax-exempt status to illegally enrich individuals connected

with the organization in some way. Public charities also tend to lose their tax-exempt status for political work on behalf of individual candidates, a strictly prohibited activity. Another major reason for loss of tax-exempt status in all types of tax-exempt organizations is a group's receipt of an excessive amount of income from an unrelated trade or business.

CHANGING TAX STATUS: A CASE HISTORY

The designations of tax-exempt entity are categories in the tax code for which each corporation must apply. The IRS has the final word on whether a corporation fits any given category. Organizations can change their selection of code if their mission or activities change. One organization, an association of nonprofit service providers, started life as a 501(c)(3). Why? The founder was candid, "We knew the options, but foundation grants were going to be critical."

Over time the organization changed its identity from charity to an entity involved in considerable lobbying on behalf of its member corporations and others like them. Nonprofit charities that begin to do substantial lobbying, in addition to having to pay a tax on lobbying above the allowable limits, must rethink their tax code election. The clock was ticking, because the IRS has the right to examine the organization's performance over a four-year period and revoke its public charity status if the IRS determines that the corporation never operated in a proper fashion.

Eventually, the association chose to change its status from a 501(c)(3) public charity to a 501(c)(4) social welfare organization. The trade-off was explicit. In return for the opportunity to carry out considerable lobbying activity, the group gave up its right to receive tax-deductible contributions. In this case, there was no real problem because the organization had long ago ceased seeking foundation grants and because increased lobbying was clearly in support of its evolving mission.

Here's the twist. That same organization realized that some of its activities, such as running educational programs, fit more comfortably in a public charity context. So, after changing its tax-exempt status, the organization immediately created a *second* corporation, wholly controlled by the newly rechristened social welfare organization, for the sole purpose of running educational programs. This was a classic case of lodging the correct activities in the correct corporate structure.

Why should nonprofit board members care about IRS policy on tax-exempt status termination when so few organizations actually lose their privileged tax status? The answer to this question is rooted in the same reservoir of public trust and social spiritedness that gives rise to the privilege of tax exemption in the first place. All of these are ways in which a tax-exempt organization behaves like something it is not, particularly when it acts as a vehicle for private enrichment.

The vast majority of nonprofit leaders are ethical, committed individuals who need not worry about their actions even remotely endangering the organization's tax-exempt status. This is the greatest counterbalance to the tiny fraction that would exploit the public trust.

But a more compelling and far more subtle reason for understanding the real risks regarding loss of tax-exempt status is to be in control of one's own organization. By citing a danger that doesn't exist, presumed experts can exercise undue sway over the actions of a board or management team, insidiously discouraging the assumption of prudent risk or the exploration of innovative financial directions. Well-meaning advisors can work in monstrous ways.