

Frequently Asked Question

Should We Form A Nonprofit?

Introduction

Anyone who has formed a nonprofit or read the "[How to Start a Nonprofit](#)" FAQ understands that it involves extensive time, dedication and expense. For that reason it is important to summarize the advantages and disadvantages of this venture. The vast majority of questions coming to the ASU Lodestar Center focus on nonprofits being organized for religious and charitable purposes. Such an organization qualifies for tax exemption under the Internal Revenue Code as a 501(c)(3). In the IRS code there are over 30 designations for nonprofits. Careful research needs to be done to determine the correct designation. This article will be limited to the examining the advantages and disadvantages of 501(c)(3)s.

Before further considering the formation of a nonprofit organization, a primary recognition is that no one owns a nonprofit. It is the governing board of directors that has the responsibility for the organization which includes the engagement of a chief staff person, paid or non-paid. A founder wants to seriously consider this relationship which places the governing board in charge.

Advantages

- **Mission Driven** - The nonprofit has at its core a "mission." Typically a number of people come together because they are committed to a common mission and incorporating as a nonprofit gives them a way to organize around that mission. In doing so they become a public trust. As long as they live up to that public trust they can expect the public to support them. The mission differs from the exempt purpose of the organization which is the language required by legal documents. The mission is the public statement of why the organization exists.
- **Tax Exemption** – Once the nonprofit is incorporated by the state, it has the privilege of obtaining tax exempt status from the Internal Revenue Service by completing a lengthy application (Form 1023). In states having corporate income tax completion of the federal tax exemption process often automatically exempts the organization from state taxes. Obtaining this designation may exempt the organization from other taxes depending on the state and local governments. A primary one is real estate (property) tax. For organizations owning extensive real property as a means of accomplishing its mission this becomes a major reason for seeking tax exempt status. Some states also exempt nonprofits from paying sales tax. (It is important to check individual state revenue laws.)
- **Receiving Donations** – Many nonprofits depend on voluntary contributions to support their mission. While being subjected to increasing definition, scrutiny and restrictions, this has become a major reason for giving. Individuals and corporations can contribute

and deduct it from their income. While there are exceptions, the vast majority of foundations require 501(c)(3) status of applicants. Units of government granting support or purchasing services also usually require organizations to have this status to be eligible.

- **Perpetual Life** – Organizations have sought to "outlive" their founders and incorporating as a nonprofit creates an entity that has a life of its own. (Examples include YMCA, Boy and Girls Clubs, Red Cross, religious congregations, etc.)
- **Employee Benefits** –Increasingly, nonprofits have developed enough support for their missions to become employers. The organization has the ability to negotiate and purchase health insurance, disability insurance, liability insurance, pensions, etc.)
- **Structure** – The nonprofit sector (frequently called the third or social sector) has developed sophisticated structures that can be copied. These include articles of incorporation, bylaws, and minutes of meetings, board actions – all of which help an organization organize its work in a lawful and productive way. Without clear cut rules, procedures, policies a diverse group of people supporting the mission can become divisive.
- **Personal Liability Protection** – Protecting the participants (directors, officers, employees, and members) from personal liability is one of the primary reasons for incorporating. The corporation becomes the legal entity providing protection from creditors who can attach assets of the corporation but not the personal assets (bank accounts, real estate, and car) of the participants listed above. It is necessary to add that this protection is not absolute and there are significant areas of potential liability. (See *How to Form a Nonprofit Corporation, 8th Edition* by Anthony Mancuso (p. 10) for major areas of potential personal liability and the FAQ on ["Risk Management."](#))
- **Other Benefits** – Depending on the mission, type of activity or needs of the employees and volunteers there may be substantial benefits related to eligibility, taxation, training, free or discounted services. Anyone researching the reasons for incorporating should consult with an experienced group providing a similar mission to identify those benefits and their potential in achieving the mission.

Disadvantages

- **Paperwork** – There was a day not so long ago that forming a nonprofit was simple. Fill out a short form to the state followed by one for the federal government and you were in business. Please look at the paper work outlined in the FAQ ["How to Start a Nonprofit"](#) especially IRS Form 1023. As the result of a huge increase of nonprofits, their complexity and size as well as abuse and scandal, the regulations (and paperwork) has exploded over the past two decades. With the reform of ongoing reporting requirements (IRS Form 990) as well as state requirements the avalanche of paper work does not stop with the formation of the corporation. Each of these not only requires paperwork; they

also necessitate complex internal controls (and paperwork) as a means of documentation.

- **Costs of Incorporation** – The forming of a nonprofit was historically free of cost (or very minimal). Due to some of the new regulations cited above the basic out of pocket expenses are at least \$500 and with legal or financial review that number quickly rises to above \$2,000.
- **Time and Energy** – It is good to think of the time and energy that goes into having a child. Only the most naïve couple disregards understanding that their lives change when their child is born. It is important to remember that incorporation gives birth to an entity that requires time and energy. Most well intentioned people underestimate this factor. It is often the reason volunteers suffer from fatigue and the mission fails.
- **Restrictions on Paying Directors** – Basic to the nonprofits is the prohibition of distributing gains to directors, officers and members as defined by the articles of incorporation. While there are no restrictions on reasonable salaries for work done on behalf of the corporation, great care needs to be taken to be compliance with federal, state and local statutes and regulations.
- **Dissolution Issues** – In the same manner as payment outlined above, the dissolution of the organization is not a means of transferring assets to individuals. Articles of Incorporation must indicate the provision for dissolution should it occur. "One of the requirements of the 501c3 tax exemption is that upon dissolution of the corporation, any assets remaining after the corporation's debts and liabilities are paid must go to another tax exempt nonprofit, not to member of the former corporation" Anthony Mancuso (p.15).
- **Political Activity Restrictions** – The involvement in governmental affairs is subject to restriction. Tax exempt organizations may actively support (or oppose) legislation and regulation but they may not support a candidate for public office or a political party.
- **Oversight** – The states have delegated the responsibility of oversight of nonprofits to either their Attorney General or Secretary of State. Active oversight is normally triggered by egregious behavior or violation of the organization's public trust. In forming a nonprofit, the founders need to know there is a legal authority in the state that has explicit oversight responsibilities should they be needed.
- **No Distribution of Profits** – As stated above should the organization post a gain at the end of an accounting period, it is prohibited from distributing it to individuals. Gains are intended to be invested in the future of the organization.
- **Sources of Capital** – Nonprofits do not have access to two forms of capital that are available to the other sectors (for profit and government). A for profit corporation can issue ownership shares in exchange for investment in the corporation. Government has the additional revenue potential – taxes. Nonprofits have four sources of capital:
 - Philanthropy: Contributions and sponsorships

- Earned Income: Membership dues; Sale of services and products
- Debt: Credit lines and other forms of borrowing
- Government: Contracts and grants.

Conclusion

It is recommended that potential nonprofits carefully study the advantages and disadvantages as they affect the mission of the organization. Proceeding to the formation of a nonprofit should occur only after determining that one or more the above are determined to be critical in the success of the mission.

Related Resources

Nonprofit Management Institute: The ASU Lodestar Center has a Nonprofit Management Institute with courses that speak to the issues raised in this article. [Click here](#) for further information and registration. The list of courses is as follows:

- Human Resource Management
- Financial Management Principles
- Leadership and Ethics
- Basic Fundraising and Resource Development
- Strategic Planning
- Results-Oriented Program Evaluation
- Laws and Ethical Issues
- Effective Board Governance
- Advanced Financial Management
- Diversity Strategies
- Effective Supervision
- Managing Volunteers
- Marketing
- The Press, Power and Politics
- Social Entrepreneurship
- Advanced Fundraising and Resource Development

Books:

- Hopkins, Bruce, *Starting and Managing a Nonprofit Organization: A Legal Guide, 4th ed.*, Wiley Nonprofit Series, John Wiley and Sons 2004
- Mancuso, Anthony, *How to Form a Nonprofit Corporation in All 50 States, 8th ed.*, NOLO Press 2007 (This publication has an excellent section devoted to the advantages and disadvantages of a nonprofit corporation, pp. 9-15)
- Andringa, Robert C and Engstrom, Ted W. *Nonprofit Board Answer Book* (BookSource, 2007) <http://www.boardsource.org>

Web sites:

- ASU Lodestar Center for Philanthropy and Nonprofit Innovation
<http://www.asu.edu/copp/nonprofit/index.htm>
- Board Source, Inc. has an excellent question and answer section
<http://www.boardsource.org/>
- Free Management Library has a section on Board of Directors
<http://www.managementhelp.org/>
- Independent Sector keeps board informed on laws and legislation affecting nonprofit governance. <http://www.independentsector.org>
- For a complete listing of internet sites with links see the "[How to Start a Nonprofit](#)" FAQ.

(This article "Should You Form a Nonprofit" has been developed by the many persons and organizations seeking assistance from the Lodestar Center for Philanthropy and Nonprofits Innovation. We invite you to add your questions and reactions through the "Ask the Nonprofit Specialist" section of the center's Web site so that we might improve and expand these FAQ.)

Please note that websites frequently change and while we endeavor to keep links current, some might not work. When you encounter such a problem you can help us by sending an e-mail to robert.duea@asu.edu so that we might investigate and make changes to our information and links.

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