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Should I Start a Nonprofit or a For-Profit? Some Basic Considerations

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This paper is intended to describe the basic considerations when deciding to form a nonprofit or for-profit legal entity. (The following considerations apply primarily in the USA and Canada. The following guidelines are not offered as legal advice, rather as general considerations.)



Should You Start a Nonprofit?

If you primarily want to make changes in society, then you should consider forming a nonprofit organization (or not-for-profit or nonprofit governmental organization). Nonprofits are focused primarily on meeting strong, unmet social/public needs, rather than maximizing profits. Nonprofit organizations usually should constrain salaries and wages to reasonable amounts (at the time of this writing, there is no standard rule to determine reasonable amounts.) So if you are interested primarily in getting rich or making a big salary, then form a for-profit (see the section about for-profits later on in this document).

Various Forms of Nonprofits

Informal Nonprofit

This is an informal gathering of people organized to meet a usually short-term and local need, e.g., to clean up the neighborhood of litter or to raise funds for a local event. You usually don't need lots of ongoing resources for these types of activities. You probably don't need to form a nonprofit corporation (see below).

Nonprofit Corporation (Chartered, Registered)

This status is granted by the state to a nonprofit organization (in Canada, status can be granted by a province or federally). People form a nonprofit corporation usually when they want to ensure that their organization is an ongoing entity apart from its members, e.g., the corporation can have its own bank account and enter into contracts. Also, members of the organization usually are not directly liable for the effects of corporation's operations (the limited liability shield), unless members engage in deliberate illegal acts for which individuals can be prosecuted.

Corporations benefit from the oversight and guidance of a Board of Directors (a requirement of corporations) – to some, this loss of power could be a disadvantage. Control of the corporation is

vested in the Board members as a body. The nonprofit corporation is owned by the community, not by the founder or Board members. Usually Board members are not paid, but they can be reimbursed for expenses.

Employees must keep the amount of their salaries and wages within reasonable limits. Often, a nonprofit must be a corporation in order to qualify for tax-exempt and/or charitable status from the IRS or Canada Revenue (see below) in order to avoid paying certain taxes and/or getting donations/funds from donors/funders.

So if you want to form a nonprofit to get donations/funding, you probably should file with your state to be a corporation – but realize that you’ll be working for a Board of Directors and you won’t own the nonprofit yourself.

Tax-Exempt Nonprofits

The tax-exempt nonprofit usually has features of a nonprofit corporation (described above) in addition to the following features. The tax-exempt nonprofit can avoid paying certain taxes. This status is granted by the Internal Revenue Service in the USA and by Canada Revenue Agency in Canada. Usually the nonprofit must be a corporation to qualify for tax-exemption. These nonprofits are constrained to providing services in accordance with their mission to meet the public need (otherwise they have to pay taxes on any revenue over a certain amount). Getting tax-exempt status requires ongoing submission of paperwork to the IRS or Canada Revenue Agency to retain tax-exempt status.

Charitable Nonprofits

The charitable nonprofit usually has the features of a nonprofit corporation (described above) and sometimes tax-exempt status in addition to the following features. Donors/funders can deduct the amount of their contributions (to the charitable nonprofit) from their tax liabilities. Charitable status is granted by the Internal Revenue Service in the USA and by Canada Revenue Agency in Canada. Usually the nonprofit must be a corporation to receive charitable status. People and funders often are much more willing to give money to a charitable nonprofit.

These nonprofits are constrained to providing services in accordance with their mission to meet the public need (otherwise they have to pay taxes on any revenue over a certain amount). This status requires ongoing submission of paperwork to the Internal Revenue Service or Canada Revenue Agency in order to retain charitable status.

Charitable nonprofits must limit the amount of lobbying that they can do (organizations that engage primarily in lobbying are usually tax-exempt, but not charitable). There often is strong, ongoing public interest in the operations of organizations, which can result in a lot of effort in the charitable nonprofit to be transparent and accountable for its operations. Often, a major challenge in these nonprofits is to generate revenue from fees because clients often have very limited funding.

If you want to form a nonprofit in order to get lots of donations/funds, then you’ll probably need to be a charitable nonprofit, but you’ll also have to report to a Board of Directors – and you won’t own the nonprofit, the public will.

Should You Start a For-Profit?

If you primarily want to make a large salary or wages or even to get rich, then you probably should start a for-profit organization. Nonprofit organizations usually should constrain salaries and wages to reasonable amounts (at the time of this writing, there is no standard rule to determine reasonable amounts). For-profit organizations very seldom receive donations as is done much more often for nonprofit organizations.

Various Forms of For-Profits

Sole Proprietorships

Sole proprietorships are formed usually by owners in order to have complete personal control of the organization and for them to receive all profits from the organization's operations. The owner is taxed for organization's profits. Most small businesses are sole proprietorships.

Partnerships

Partnerships are formed by owners of the organization in order for them to benefit from the expertise, perspectives, investments, energy and attention provided by all partners to the organization. The organization is owned by the partners, usually according to a partnership agreement. The profits of the organization are shared among partners, again usually according to a partnership agreement. Each partner usually is taxed for the amount of profit that he/she receives of the profit.

Corporations

For-profit corporations, like nonprofit corporations, are formed to ensure an ongoing entity that is separate from the members of the organization, and the organization can operate on its own legally, e.g., to have its own checking account and enter into contracts. The members of the organization are not directly liable for the effects of the organization's operations (the limited liability shield) unless the members engage in deliberate illegal acts for which individuals can be prosecuted.

Corporate status is granted by the state, province or federal level. Corporations can benefit from the oversight and guidance of a Board of Directors (required for corporations). Board members usually are paid for their services.

Corporations can generate funds from distribution of stock to owners. The corporation is owned by the stockholders. The corporation can distribute earnings in the form of dividends to owners of the stock. The corporation is taxed for its profits, and the owners also are taxed for earnings and equity/stock distributed to the owners.

Limited Liability Companies (LLCs)

The Limited Liability Company can enjoy the benefits of the corporate liability shield and its owners can choose to be taxed as sole owners (the nature of a sole proprietorship) or as a corporation or a partnership.

The LLC can be member-managed (if it is formed to be owned by members) or manager managed. Member-managed resembles a partnership and manager-managed resembles a corporation. A major advantage of the LLC is that profits can be passed through to the owners, resulting in taxation only at the owner level (if the LLC elects not to be taxed as a corporation). An advantage is that the owners need not report to a Board of Directors.

Lines Between Nonprofits and For-Profits Are Blurring

The lines between the purposes of maximizing revenue and serving a public need are blurring. Nonprofits are encouraged to act “more like business,” to watch the bottom line, to maximize revenues from fees to invest back into the nonprofits’ programs. Nonprofits also are starting subsidiary for-profit ventures to generate profits to invest in the nonprofit’s mission and programs. For-profits are encouraged to work according to a triple bottom-line, to focus on social responsibility and community impact, in addition to making a profit.