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Nonprofit Basics

Nonprofit corporations are entitled to grants, tax exemptions, and limited liability protection.

Nonprofit (or not-for-profit) corporations work well for all sorts of groups, from artists and musicians to people active in education, health, and community services. Often the reason for obtaining nonprofit status is simple -- it's usually a requirement for obtaining funds from government agencies and private foundations. Obtaining grants, however, is not the only reason to incorporate as a nonprofit.

There are two additional important benefits of forming a nonprofit: tax-exempt status and personal liability protection.

Tax-Exempt Status

Many nonprofit groups seek nonprofit corporate status to obtain exemptions from federal and state income taxes. The most common federal tax exemption for nonprofits comes from Section 501(c)(3) of the Internal Revenue Code, which is why nonprofits are sometimes called 501(c)(3) corporations.

If your group obtains tax-exempt status, not only is it free from paying taxes on all income from activities related to its nonprofit purpose (), but people and organizations that donate to the nonprofit can take a tax deduction for their contributions.

Protection From Personal Liability

Forming a nonprofit corporation normally protects the directors, officers, and members of the nonprofit from personal liability for the corporation's debts and other obligations. Called limited liability, this shield ensures that anyone who obtains a judgment against the nonprofit can reach only the assets of the corporation, not the bank accounts, houses, or other property owned by the individuals who manage, work for, or participate in the business.

Consider a nonprofit symphony that is sued by a visitor who falls through a poorly maintained railing on a staircase. If the court finds in favor of the visitor, it could issue a judgment against the nonprofit for an amount greater than the nonprofit's insurance coverage. The amount of the judgment is a debt of the corporation, but the directors, officers, and members are not personally responsible for paying it. By contrast, if an unincorporated association of musicians owned the premises, the principals of the unincorporated group could be required to pay the judgment amount out of their own pockets.

Exceptions to the Limited Liability Rule

In a few situations, people involved with a nonprofit corporation can be held personally liable for its debts. A director or officer of a nonprofit corporation can be held personally liable if she:

personally and directly injures someone
personally guarantees a bank loan or a business debt on which the corporation defaults
fails to deposit taxes or file any necessary tax returns
does something intentionally fraudulent, illegal, or clearly wrong-headed that causes harm, or
co-mingles nonprofit and personal funds.

To cover some of these exceptions, reasonably priced insurance is available to protect volunteer directors, who may be reluctant to serve without it.

Believe it or not, there are still more reasons to incorporate your nonprofit group; for more, read .

Who Should Consider Becoming a Nonprofit

The types of groups that typically seek nonprofit status vary widely. Here's a partial list of associations that may be eligible:

- childcare centers
- shelters for the homeless
- community health care clinics and hospitals
- museums
- churches, synagogues, mosques, and other places of worship
- schools
- performing arts groups, and
- conservation groups.

If your group isn't on this list, it doesn't mean you won't qualify for tax-exempt status. As long as your group's activity is charitable, educational, literary, religious, or scientific, you should be able to get a tax exemption.

Forming a Nonprofit Corporation

Forming a nonprofit corporation is very similar to forming a regular corporation: You must file "articles of incorporation" with the corporations division (usually part of the secretary of state's office) of your

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state government. But unlike regular corporations, you must also complete federal and state applications for tax exemptions.

After filing this initial paperwork, you will create corporate bylaws, which lay out the operating rules for your nonprofit. Finally, you elect the initial directors of your nonprofit and hold an organizational meeting of the board.

Running a Nonprofit Corporation

Most nonprofit corporations are run by a board of directors -- called trustees in some states. The directors set policy for the nonprofit and are usually actively involved in the work of the corporation. Officers (who may also serve on the board) carry out the day-to-day business of the corporation and sometimes receive salaries.

Depending on its structure, a nonprofit may or may not have formal members with voting rights. If the nonprofit does not create a formal membership structure, the only people who participate in the management of the nonprofit are the directors and officers.

Nonprofit corporations must observe most of the same formalities as regular corporations. These include keeping good corporate records, holding and preparing minutes of directors' (and possibly members') meetings, and maintaining a separate bank account.

Unlike regular corporations, a nonprofit corporation cannot distribute any profits to its members, contribute money to political campaigns, or engage in lobbying activity, except in very limited circumstances.

Ending a Nonprofit Corporation

Nonprofits are not actually owned by anyone and therefore cannot be sold. If the directors of a nonprofit corporation decide to dissolve it, they must pay off all debts and obligations of the nonprofit and distribute all of its assets to another tax-exempt nonprofit corporation.