



U.S. NONPROFIT ORGANIZATIONS: THE BASICS¹

Introduction

The term *private nonprofit organization* is used to describe organizations that are not a part of – are independent of – the government and the corporate sector. This term refers to one of the most important characteristics of a nonprofit organization: it is independent of both the *public or government sector* and the *private or corporate sector*.

The concept of an independent sector has developed over centuries, but has accelerated in recent decades, with fundamental changes in the political situation worldwide. The U.S. and many developing democracies share the belief that it is impossible to create and maintain economic and political freedom and equitable access to societal resources if the power to create change is concentrated in the government and corporate sectors. There must be a balance to their power and influence – and the independent sector of nonprofit organizations can provide that balance, acting as a voice that calls attention to problems and needs and helps to address them. Groups of residents, seeing a community or national need, can come together around a common mission and form an organization to address that need.

The independent sector provides a source of creative experimentation and problem solving, and offers diverse approaches to meeting community needs. Nonprofit organizations have more flexibility than government agencies or large corporations, so they can respond quickly to changing community needs. John W. Gardner, an expert on nonprofit organizations, asserted that in the United States, "Virtually every significant social idea in this country has been nurtured in the nonprofit sector," from public social services to women's suffrage.

One of the most basic concepts of nonprofit organizations is that they are established and governed by volunteers. Many nonprofit organizations have paid staff. However, the concept of nonprofit organizations is based on a belief in voluntarism and resident involvement -- the belief that individuals can make a difference, that even a small group of people, acting together, can change public policies and make available services which have a significant effect on society.

¹ Prepared by Emily Gantz McKay when President of Mosaica. Originally prepared in 1994 for an organizational development project in Croatia, carried out with Refugee Women in Development. Revised in August 2003 by Hilary Binder-Aviles to provide a summary in question and answer format. Further revised and updated by Emily in 2015 and in 2020.

The word "volunteer" is closely related to the term "voluntary" – "by choice." Volunteers are people who become involved with a group, and stay involved, by choice. While many people feel similarly committed to their jobs, people also may remain in their jobs primarily because of the salary or security it offers, not because they would voluntarily choose that job over other possible employment. When people volunteer, they do make this choice.

Q&A on Nonprofits in the U.S.

Question: What is a private nonprofit organization?

Answer: The term *private nonprofit organization* is used to describe organizations that are not a part of – are independent of – both the *public or government sector* and the *private or corporate sector*. In much of the world, nonprofits are known as NGOs, nongovernmental organizations – but that term doesn't reflect the fact that they are also not-for-profit.

Question: What are the legal requirements of a nonprofit organization?

Answer: To obtain and maintain federal tax-exempt status as a 501(c)(3) organization in the U.S. (the most common nonprofit status), a nonprofit organization must have the following characteristics:

1. **Purposes:** The organization must exist for humanitarian, charitable, educational, or other purposes that can be described as contributing to the public good.
2. **Governance:** The organization must have some group of people responsible for ensuring that it meets various legal requirements. Usually, this means a volunteer Board of Directors that sets policies and provides oversight of all activities and funds.
3. **Independence:** The organization should operate independently, not as part of either government or the private sector.
4. **Nonpartisan status:** 501(c)(3) nonprofit organizations must not engage in partisan political activity. They must not support or oppose candidates for office or political parties. They are permitted to do legislative advocacy or "lobbying." This can include grassroots lobbying to get residents to urge their county supervisors, state legislators, or Congress members to take specific action. It also includes direct lobbying with legislators. However, organizations must follow federal regulations on lobbying and may not use federal grant funds to lobby.
5. **Fiduciary responsibilities:** The organization must ensure that contributions and other funds received are used for tax-exempt purposes involving public benefit, not for the personal gain or benefit of specific individuals.
6. **Public accountability:** Because a nonprofit organization exists for the public good, it must be accountable to the public. Nonprofit organizations are required to make information about their finances and their activities available to the public.

In addition to meeting federal requirements, nonprofits are generally required to file regular reports every 1-2 years with the state in which the nonprofit is incorporated, and to meet its requirements regarding nonprofit organizations.

Question: Nonprofit organizations can be formed under several different parts of Section 501(c) of the Internal Revenue Code. What is the difference between 501(c)(3) and other types of nonprofits?

Answer: A 501(c)(3) organization is a nonprofit formed for “religious, charitable, or educational purposes.” It can only engage in a limited amount of legislative or grassroots advocacy (lobbying) or political activity, and contributions to it are tax-deductible for the donor. A 501(c)(4) organization is usually a civic league or “social welfare” organization. It is allowed to do more lobbying and to be involved in political activity, but donations to such organizations are not tax-deductible. Here is a quick summary of some other types of 501(c) organizations: 501(c)(1) – corporations organized under an Act of Congress, including federal credit unions; 501(c)(5) – labor and agricultural unions; 501(c)(6) – business leagues and Chambers of Commerce; 501(c)(7) – social and recreational clubs (like country clubs); and 501(c)(8) – fraternal beneficiary societies.² This document focuses on 501(c)(3) nonprofits.

Question: What is a “grassroots” or “community-based” nonprofit organization?

Answer: Grassroots or community-based organizations grow out of and have strong links to people from a particular geographic, racial/ethnic, or other community. Often their boards of directors are made up primarily of people from that community.

Question: Why do nonprofits exist in the United States?

Answer: To meet local needs and address issues and problems that the private sector and the government do not address—or do not address as well. Nonprofits provide many services paid for at least partly by local, state, or federal government, including services that in other countries are provided directly by the government agencies. The United States has a long history of groups of residents seeing a community or national need, coming together around a common mission, and forming an organization that helps meet that need. A Supreme Court case long ago established the right to form associations as a basic right, part of the constitutional right of assembly, so the formation of a nonprofit does not depend on governmental approval.

Question: Why are nonprofits important?

Answer: Nonprofits are creative problem solvers that offer diverse approaches to meeting community needs. They are close to the communities they serve, know their needs, and can respond or change direction more quickly than the government to changing community needs. Often, nonprofits use volunteers to do a lot of their work, so they can often get things done with less money than the other sectors. Nonprofits can also serve as a voice for people who would otherwise have little influence on public policies or decisions about use of resources.

² For information on these other types of 501(c) organizations, see the list from IRS Publication 557 on the Charity Navigator website, at <https://www.charitynavigator.org/index.cfm?bay=content.view&cpid=1559>.

Question: How are nonprofit organizations different from private corporations?

Answer: There are two especially important differences.

- **A nonprofit organization exists for the *public good*, and has no individual owners.** Its governing board is responsible for ensuring that its work benefits the public, or some specific segment of the public. If any of its activities makes money – if there is a surplus at the end of the year – that money (called a *surplus* rather than a *profit*) goes back into the work of the organization.
- **A nonprofit organization is established and governed by volunteers.** The word "volunteer" is closely related to the term "voluntary" – "by choice." Volunteers are people who become involved with a group, and stay involved, by choice.

Question: How does a nonprofit organization become legally established and tax-exempt?

Answer: There are two steps:

1. **Incorporation:** First your organization should incorporate, usually in the state where it will be headquartered. This means meeting the requirements of the state, which are based on its nonprofit law. Incorporating usually requires providing Articles of Incorporation that meet state requirements regarding purpose, activities, etc.; having a founding Board of Directors (usually at least three people); naming a Registered Agent with an address to which all official correspondence will be sent; and paying a small fee. There is no requirement that a nonprofit be incorporated, but incorporation provides a number of protections, including limiting the individual liability of members and directors; it also provides credibility and clarifies tax status.
2. **Recognition of Tax-exempt Status:** Once incorporated, if you feel you need tax-exempt status to raise funds (and do not decide to become a project of an existing nonprofit, tax-exempt organization), you must submit an application for recognition of your tax-exempt status to the Internal Revenue Service (IRS). It is least complicated to prepare the application when the organization is new and does not yet have many assets. If your organization files within 27 months after incorporation, contributions are considered tax-exempt retroactively to the date of incorporation. *Beginning on January 31, 2020, the application must be submitted online through [Pay.gov](https://www.pay.gov), not mailed.* You will file one of these forms:
 - **Form 1023-EZ:** Some new, small nonprofits that expect to receive \$50,000 or less in gross annual receipts can file IRS Form 1023-EZ, which is simpler to complete and does not require any attachments. The IRS has a 30-question worksheet to use in determining if your organization is eligible to file Form 1023-EZ. As of April 2020, the filing fee was \$275.³
 - **Form 1023:** Most nonprofits will need to prepare and file Form 1023, a fairly complicated application; organizations often get legal or other expert assistance in preparing it. Detailed instructions are provided by the IRS. The form is 30 pages long,

³ Information about use of Form 1023-EZ are at <https://www.irs.gov/forms-pubs/about-form-1023-ez>. Instructions are at <https://www.irs.gov/instructions/i1023ez> and the worksheet to determine eligibility is at the end of the instructions.

though many sections apply to only certain types of nonprofits.⁴ To complete the form, you will need to provide information such as the following: a narrative description of the organization’s “past, present, and planned activities”; a list with positions and mailing addresses of officers, directors, and trustees; a copy of your conflict of interest policy; and a description of each current or planned fundraising program; and financial data including revenues and expenses for the current tax year and either three prior years or two future years. The form requires a number of attachments, such as your Articles of Incorporation, Bylaws, and supplemental responses if your answers to the questions won’t fit in the space provided on the form. They must be consolidated into a single attachment when you upload your application. The filing fee is \$600.

Question: Do nonprofit organizations pay taxes?

Answer: Nonprofit organizations that meet certain requirements enjoy a special tax-exempt status in the U.S. They are not required to pay taxes on their income from contributions, grants, or contracts, or from other income related to their purpose or mission. They are usually exempt from local and/or state sales tax, if they file the appropriate paperwork to prove that they are eligible for this exemption. The contributions made to such organizations by individuals, foundations, or corporations can be deducted from the donor’s income tax. However, nonprofits do have to file a form with the IRS each year – a Form 990, which comes in several versions based on the organization’s budget size and type of nonprofit. For small nonprofits with revenues of less than \$50,000, Form 990-N is essentially an electronic postcard to complete and file online. *If you do not file the required 990 form each year, your nonprofit status can be revoked.*

Question: What can nonprofit organizations do?

Answer: Nonprofit organizations carry out a very wide range of activities related to their specific missions. Among the most common are the following:

- Direct human or technical services, from counseling to education to housing construction and health care. Many universities and hospitals are nonprofit organizations. The first U.S. nonprofit was Harvard, incorporated in 1636.
- Religious activities (Churches, temples, mosques, and synagogues are typically nonprofit organizations).
- Indirect assistance to individuals, such as information and referral services to help people locate needed services or support.
- Public information and education.
- Research, public policy work, and/or advocacy to influence policies, programs, and/or priorities – but NOT involvement in political campaigns, and legislative advocacy (“lobbying”) is regulated and limited.

⁴ Form 1023 is available at <https://www.irs.gov/pub/irs-pdf/f1023.pdf>; the instructions as revised in January 2020 are at <https://www.irs.gov/pub/irs-pdf/i1023.pdf>.

Question: What are the sources of funding for nonprofit organizations?

Answer: Among the most common sources of funding for nonprofit organizations are individuals, government agencies, foundations, corporations, religious groups, and special events (such as an awards dinner or the sale of T-shirts). Other sources include third party payments for services provided (for example, Medicaid payments to health clinics as reimbursement for health services), earned income (such as fees for services or from the sale of materials), and membership dues.