
Nonprofit Law Resource Library

Starting Up: Nonprofit & Foundation Basics – Question & Answer

Q & A

Starting Up: Nonprofit & Foundation Basics

- 1. I've heard that the IRS allows unincorporated groups as well as corporations to become tax-exempt and tax-deductible. Two questions: Is this true? And, if so, what is the advantage in incorporating?**

There are a number of factors to weigh in considering whether to incorporate. The three main factors, in order of importance, are liability, liability, and liability.

In answer to your first question, the IRS does allow unincorporated groups to obtain tax-exemption. Simply stated, nonprofit organizations have two legal identities. At the state level, they are either charitable trusts, unincorporated associations, or nonprofit corporations. At the federal level, they have status as one of the class of 501(c)(2) through 501(c)(25) tax-exempt organizations.

Status at one level is not contingent upon status at the other. The IRS application for tax-exemption itself asks which of the three entities the organization has chosen. As a practical matter, most of the estimated 900,000 tax-exempt organizations in this country are incorporated 501(c)(3) public charities.

Most nonprofits incorporate for the same reason businesses do. You may have noticed the appellation "Ltd." at the end of some store names. In the U.S. this has no legal significance and is merely a flourish. In Great Britain, where the corporate form originated, it signifies limited liability and is the equivalent of our "Inc."

Limited liability is the key to the corporate form. It means that the corporation itself, rather than the individuals involved with the corporation, absorb most liabilities incurred by the corporation. Therefore, as a nonprofit director, officer, or manager your personal assets are at a lower level of risk with corporate protection.

As I am sure you've seen in this time of increasing litigation, courts have become more willing to "pierce the corporate shield" and assign personal liability, particularly in instances involving gross negligence. However, the corporate entity continues to offer a layer of protection, particularly when combined with other protective measures such as the

inclusion of good indemnity and liability provisions in organizing documents, reasonable liability insurance, and clearly defined board and staff responsibilities.

In addition, many states recently have passed statutes providing immunity for voluntary directors and officers of charitable corporations who act in good faith.

I would therefore recommend the corporate form for most tax-exempt entities. Even among exempt organizations that in past decades were traditionally unincorporated, such as volunteer groups or charitable trusts, incorporation provides helpful protection against liability. Corporate status is especially advisable since the cost and effort of obtaining and maintaining corporate status is minimal in most states.

Other primary reasons for incorporating include:

- Corporate status provides credibility to the organization in its dealings with third parties and the community.
- Governmental and foundation funders require it or at least want to be assured that their scarce dollars are used by properly established organizations.
- Maintaining clear lines of accountability and authority can be easier under the structure of a formally constituted corporation, governing board, and set of bylaws.