

September 30, 2024

Nonprofit vs. Business Corporation: Which Structure is Right for You

Many individuals wish to engage in an organized effort to make an impact. Such impact can be achieved through nonprofit or for-profit business corporations. There are significant and fundamental differences between the two types of entities. A threshold question is whether a founder has the public interest in mind, or if making a profit for themselves and others a primary goal. Some founders assume that forming a nonprofit organization means that donations and grants will start flowing into a nonprofit as soon as it has tax-exempt status, but that is an unrealistic expectation.

This Alert is intended to provide an overview of the fundamental differences between the two main types of corporate entities, a nonprofit corporation and a business corporation, and the factors to be considered when deciding which type of entity is right to achieve your goals. Understanding the distinction between running a business and operating a nonprofit organization is critical to entity selection.

What is the first step?

The first step of forming a corporation is to develop a business plan. This involves setting out your goals, projections, and metrics to achieve desired outcomes. This will take time and effort as well as trial and error. A business plan, whether for a for-profit or nonprofit corporation, should project sources of revenue and expenses. Where will revenue come from? Selling goods and services? Investments or donations from friends and family? Contracts or grants from the government or private foundations? Are these estimates based on research and due diligence or on assumptions? Do you have expressions of interest or commitments? Have you explored all available funding options? The plan needs to include viable funding sources. If there are no identifiable sources of support available, a nonprofit will have difficulty succeeding.

Consider someone interested in forming a youth martial arts program in New York City. They have the option to either provide classes for a market-rate fee, or have the classes be available to certain children for free (or perhaps at a 'sliding scale' based on ability to pay). If the classes are free or low-cost, the founder will have to seek revenue elsewhere, likely through grants and donations.

A business plan will give the first clue as to whether a for-profit or nonprofit approach is more appropriate. Once the goals are settled upon and the means for achieving those goals are identified, the founders can move on to the legal process of creating a corporation.

Why incorporate?

The primary benefit to forming any type of corporate entity is to limit personal liability. If a corporation has liability, such as unpaid debts or liability for personal injury, the creditor must try to recover from the corporation—not its individual employees, shareholders, or Board members. As a separate legal

entity, only assets of the corporation are subject to corporate debts (save for certain exceptions). Thus, incorporating protects individual actors when they engage in their corporate activities in good faith.

Corporations are governed by a Board of Directors and have bylaws as a governance tool. Corporations are often incorporated in Delaware or in the state the corporation will be doing business.¹ Corporations can also, among other things, enter into their own contracts, sue, and be sued. All of these powers can be important to running an enterprise, whether a for-profit or nonprofit.

What are the key differences between a nonprofit corporation and a for-profit business corporation?²

Fundamentally, for-profit business corporations³ and nonprofit corporations⁴ have different purposes, tax statuses⁵, and governance structures. These three issues are key to deciding which structure works best for you.

Purposes

Both corporation types have a corporate purpose that is written into its foundational document, the certificate of incorporation. Generally speaking, a business corporation's purpose is to maximize profit by selling goods or services. The furtherance of this business endeavor is the main motivation for the business corporation.

On the other hand, a nonprofit corporation's motive is to advance its charitable purpose. A charitable purpose can be broad ("any purpose for which corporations may be organized under the New York Not-for-Profit Corporation Law as a Charitable Corporation"), narrow ("to serve community members of this particular neighborhood"), or something in-between ("to alleviate poverty in New York City"). To qualify for federal tax exemption, as discussed immediately below, a nonprofit corporation's mission-based programming must generally relate to religious, charitable, scientific, or educational purposes.⁶

Tax status

There is often a misconception that a nonprofit corporation is the same as a tax-exempt entity. This is not the case. Nonprofit status refers to incorporation status under state law; tax-exempt status refers to federal income tax exemption under the Internal Revenue Code. Most nonprofit corporations qualify for

¹ For more information on this choice, see: [Incorporation in New York v Delaware Legal Alert.pdf \(lawyersalliance.org\)](#)

² There are other structures that can be explored, e.g. a limited liability company, however the focus of this alert is to address the fundamental differences between nonprofits and for-profit businesses. It is not an overview of all structuring options.

³ These type of corporations will be referred to as "business corporations" as they are governed by the New York Business Corporations Law.

⁴ The accurate terminology in New York State is "Not-for-Profit Corporation" but, for simplicity, this legal alert will refer to them as nonprofit corporations. The meaning is identical.

⁵ Business corporations can take a variety of forms: LLCs, C corporations and S corporations to name a few. There are different tax and other consequences to each of these forms, but such level of detail is beyond the scope of this legal alert.

⁶ As laid out in section 501(c)(3) of the Internal Revenue Code: [26 U.S. Code § 501 - Exemption from tax on corporations, certain trusts, etc. | U.S. Code | US Law | LII / Legal Information Institute \(cornell.edu\)](#)

federal income tax exemption under one of 25 subsections of Section 501(c) of the Internal Revenue Code.

If a corporation is tax exempt under Section 501(c)(3) of the Internal Revenue Code, it is exempt from federal income tax and donors to the corporation are eligible for their own charitable tax deductions.⁷ Other tax-exempt entities (such as 501(c)(4) social welfare organizations and 501(c)(6) chambers of commerce) are also exempt from income tax but do not afford their donors a tax deduction.

Business corporations, on the other hand, must pay corporate tax in the normal course. Tax-exempt entities may be required, in some limited circumstances, to also pay corporate tax.⁸

Governance structure and employee compensation

Both for-profit and nonprofit corporations are governed by a Board of Directors. Nonprofit corporation Board members are typically volunteers, while business corporation Board members are often paid.⁹

Business corporations have shareholders who own the corporation. Nonprofits do not. Unlike a business corporation, which can distribute profits to its shareholder-owners, no one 'owns' a nonprofit corporation. No part of a nonprofit's net earnings can unreasonably benefit any director, officer, or any private individual, and no officer or private individual can share in the distribution of any of the nonprofit assets in the event the corporation dissolves.¹⁰ Nonprofit assets must be used for charitable purposes and not personal enrichment of any private parties.

There is also a significant difference between nonprofit corporations and business corporations when it comes to personnel. Nonprofits may only pay reasonable compensation to employees. Nonprofits may, therefore, rely on volunteers to help carry out the corporation's mission. Business corporations have more flexibility in their compensation structures but may not use volunteers to perform for-profit work.

Finally, nonprofit corporations must file an information return, called a Form 990, with the IRS every year. This is publicly accessible and promotes transparency in the nonprofit sector. For-profit tax filings are not necessarily publicly accessible.

The Decision: Nonprofit Corporation vs Business Corporation

Think again of the proposed youth martial arts program. Which approach makes the most sense? That depends on the founder's goals. If her goal is to maximize profit for herself or her investors with these classes, then a business corporation may be best. If the business corporation is her preferred method, that does not mean that a public good still cannot be a priority for the corporation (kids may still enjoy the classes!). It only means that, legally, making a profit is the primary goal. There is also less public reporting required of business corporations, which may be a benefit if privacy of finances is a concern.

⁷ 26 U.S.C. § 170.

⁸ For more information, see:

[Basics of the Federal Unrelated Business Income Tax on Nonprofits Legal Alert.pdf \(lawyersalliance.org\)](#)

⁹ For more information on this issue, see: [Board Compensation Legal Alert.pdf \(lawyersalliance.org\)](#)

¹⁰ See: [Private Benefit Doctrine Legal Alert.pdf \(lawyersalliance.org\)](#)

If, on the other hand, she wants to provide low-income youth in a community with an extracurricular activity or share her love of martial arts more broadly, a nonprofit corporation may be better. Since the mission is charitable, she would want to apply for 501(c)(3) status to take advantage of the tax benefits of being a charitable nonprofit corporation. This would make the organization eligible for funding through foundations, government agencies, and philanthropy.

Conclusion

There is no one way to accomplish a founder's or entrepreneur's goal. There are benefits and drawbacks to each approach one should carefully consider his or her goals before taking the steps to form a corporate entity.

This Alert is meant to provide general information only, not legal advice. If you have any questions about this alert please contact us at resourcecall@lawyersalliance.org or visit our website at www.lawyersalliance.org for further information. To become a client, visit www.lawyersalliance.org/becoming-a-client.

For his assistance in preparing this Legal Alert, Lawyers Alliance would like to thank Germaine Grant, a legal extern from Skadden, Arps, Slate, Meagher & Flom LLP and Holden Smith, a legal intern from George Washington University Law School.

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