

# 501 C's Fill a Void

By Greg Varhaug

A man in a dark suit is watering a green plant with a watering can. The plant's leaves are made of US dollar bills. The ground is cracked and dry, and the background is a cloudy sky.

**N**onprofits make it possible to run professional enterprises that would not be commercially sustainable as for-profit businesses. No longer a “lunatic fringe” within the business community, the nonprofit sector in the United States now accounts for more than 10 million jobs, or around 10 percent of all private employment.

A 2012 report from the Johns Hopkins Center for Civil Society Studies entitled *Holding the Fort: Nonprofit Employment During a Decade of Turmoil* states, “Indeed, nonprofits have been holding the fort for much of the rest of the economy, creating jobs at a time when other components of the economy have been shedding jobs at accelerating rates. This striking pattern holds for nearly every state and for most major fields of nonprofit activity.” The study found that between 2000 and 2010, the nonprofit sector grew by 2.1 percent annually, while for-profit jobs decreased by an average of

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0.6 percent each year. This shift is happening at a time when the role of nonprofits in society is changing, as new modes of organization between business and government evolve.

## What Is A Nonprofit?

The term “nonprofit” usually refers to an organization recognized by the IRS as qualifying for nonprofit status under Title 26, section 501, 509, or 527 of the United States Code. Nonprofits are private institutions that can legally receive public money. Their profits are tax exempt, though some of their activities, like

paying staff, are taxable. The tax-exempt nonprofit organizational model is used today in nearly every country.

In the United States, the most common nonprofits are 501(c)(3) organizations concerned with advancing education, the arts, and the general welfare. But there are other types of nonprofits, including charitable foundations, advocacy groups, PACs, public charities, and supporting organizations. Groups like Alcoholics Anonymous are recognized as nonprofits, even though they have no real formal organization. The same applies to church groups.

Like any business, nonprofits can sell goods and services for a profit. In fact, nonprofits can make as much money as they want, any way they want. But not all of their profits may be tax-exempt, depending on how those profits are earned and distributed by the nonprofit. For example, the Girl Scouts make hundreds of millions of dollars each year selling cookies. But there are restrictions on what they can do with that income.

Every nonprofit has a specific purpose, as outlined in its charter or articles of incorporation. The profits made from activities associated with that purpose are tax exempt; for example, an educational nonprofit that charges for tutoring isn't taxed on those profits. But it's common for nonprofits to create separate profit centers for activities unrelated to their original purpose. Owing to the unique nature of their pursuits, it's not unusual for nonprofits to discover opportunities for profitable side ventures—money on the table. Profits from unrelated activities are subject to regular state and federal taxes. Nonprofits are barred from distributing profits to people directly associated with the organization, especially the officers and board. To protect their tax-exempt status, nonprofits must prevent conflicts of interest.



## Why Are Nonprofits Tax Exempt?

The reasons for exempting nonprofits from taxation are rooted in our history. The 501(c)(3) designation only dates back to the Revenue Act of 1954. But nonprofits in America date back to colonial times. As the IRS explains, “The origins of the tax-exempt sector in the United States predate the formation of the republic. [T]he early settlers formed charitable and other ‘voluntary’ associations, such as hospitals, fire departments, and orphanages, to confront a wide variety of issues and ills of the era.” They continue, “[V]oluntary associations . . . with their well-established structures and programs, were able to fill a gap in social welfare programs where the young government’s efforts proved insufficient.” Nonprofits are granted tax-exempt status because they perform roles that benefit the society as a whole—functions that might otherwise fall on the government. Among the many “thousand points of light” are thousands of nonprofits.

Dr. Peter Dobkin Hall is a senior research fellow at the Hauser Center for Nonprofit Organizations at Harvard University. In a recent publication, he points out that “the concept of ‘nonprofit organizations’ as a unified and coherent ‘sector’ dates back only to the 1970s.” He also states that the postwar period saw an explosion in the number of nonprofits; more than 90 percent of today’s nonprofits were established after 1950.

Dr. Hall says that our modern notions about public versus private enterprises had no corollary in the history of early America. He notes, “There was no clear demarcation between the public and the private realm. All corporations, to the extent that they were permitted to exist, were considered public agencies.” Further, in the 18<sup>th</sup> century, institutions like schools, municipalities, and churches “accepted gifts and bequests from donors and held them in trust as endowments, though it would be decades before American courts would have the power to enforce or adjudicate trusts.”

### What Kinds of Work?

Nonprofits engage in a wide range of activities. A few better-known examples are the International Red Cross, the National Rifle Association, the Make-A-Wish Foundation, the Wounded Warrior Project, the AARP, and Save The Children. Nonprofits include colleges; hospitals; federal credit unions; groups dealing with animal welfare, workforce training, and assisting the elderly; and arts organizations.

Before his retirement, Rob Seible was the choral director at Houston’s High School for the Visual and

Performing Arts for 34 years. He’s currently choirmaster at Houston’s Bering Memorial United Methodist Church. A few years ago, he formed a vocal group, Vox – The Rob Seible Singers, comprised of some of the top talent from the Houston Grand Opera, local music schools, and musical-theater groups. In order to cover the group’s expenses, and so he could give the group’s members at least a small compensation for their labors, he established a nonprofit.

Vox comprises 19 members. The group has established a reputation for both excellence and the sheer ambition of their productions. Last year, they combined forces with two other local vocal groups and a band to stage a triumphant performance of Leonard Bernstein’s *Mass* at Houston’s St. Philip Presbyterian Church. Composed in 1971 and first performed at the opening of the Kennedy Center, this controversial piece had never before been performed in its entirety in Houston.

The expenses of staging a public performance like *Mass* are greater than you might think. Along with the money required to transport more than three dozen people back and forth to a dozen rehearsals in a rented rehearsal space, it also costs money to rent the venue and buy the score.

(That’s if your request to perform the piece is even approved by the license holders.) Depending on the performance, there are usually between three and six instrumentalists, most often union musicians. They have to be: it’s virtually impossible to find volunteers who can reliably perform music this specialized to a professional standard.

The fact that Seible has to schedule his group’s performances around those of the Houston Grand Opera is only one factor that limits the commercial scope of his project. This is an example of how nonprofits adjust to limitations that a for-profit business couldn’t accommodate. Vox is just one Houston arts nonprofit that probably couldn’t survive as a for-profit business without severely compromising its artistic vision.

### Political Nonprofits

501(c)(3)s are not supposed to engage in direct political campaigning. This applies to campaigns for a particular party or candidate, and to attempts to influence ballot measures. They are permitted to educate the public, and they’re allowed to lobby. The amount an organization can legally spend on lobbying is usually based on a percentage of its income. This means that, in absolute terms,

# A Tale of 2 Foundations



**5** 01(c)(3) organizations are divided into “public charities” and “private foundations.” Most of the better-known nonprofits are public charities. But a number of famous private foundations also exist. According to the Foundation Center, the Bill and Melinda Gates Foundation is currently the largest nonprofit in the United States, with assets of over \$34 billion, followed by the Ford Foundation and the J. Paul Getty Trust, with holdings of over \$10 billion each.

Dr. Peter Dobkin Hall, in his paper “Historical Perspectives of Nonprofit Organizations in the United States”, describes how the modern foundation evolved. “As taxes on incomes and estates increased, the founders of the huge fortunes built in the boom years of the twentieth century were increasingly likely to use foundations as mechanisms for avoiding taxation. When Henry Ford died in 1947, stock in his closely held company was divided into two classes. The voting stock was retained by the family, and the nonvoting securities were given to the Ford Foundation, which sold them at an immense profit. The Ford Motor Company passed to the next generation without paying a penny in taxes—and the [then] largest foundation in the world was created in the process.”

Herb Robertson, in his book, *The ABCs of De*, describes the workings of the DeGolyer Foundation, established in accordance with the will of Everett Lee DeGolyer Sr., who died in 1956. DeGolyer, who co-founded DeGolyer & MacNaughton, Inc. in 1936, was a legendary wildcatter, a philanthropist, and an important Dallas civic leader.

One of the tasks of the DeGolyer Foundation was to manage a collection of more than 11,000 rare books that would form the basis for the DeGolyer Library at SMU. That collection was expanded in the years that followed; it now contains more than 110,000 volumes, 2,500 manuscript collections, and a half million photographs.

In October 1974, as stipulated in DeGolyer’s will, the foundation elected to transfer all of its assets to Southern Methodist University. This included securities, an endowment, and three separate book collections. El Rancho Encinal, DeGolyer’s Garland Road mansion overlooking White Rock Lake, was transferred to the university by a deed of gift. With the transfer of all of its assets to SMU, its work was completed. The DeGolyer Foundation ceased to exist on November 30, 1974.

Two years later, SMU sold El Rancho Encinal to the city of Dallas. Shortly after that, the Dallas Arboretum and Botanical Gardens opened on the DeGolyer estate. (DeGolyer had been, for a time, president of the Dallas Arboretum Society.) In 1980, the city expanded the Botanical Gardens when it acquired the 22-acre camp estate adjoining the DeGolyer estate. The combined properties cover 44 acres. Today, the Dallas Arboretum and Botanical Gardens are the most visible portion of DeGolyer’s legacy to the city he loved. During his lifetime, DeGolyer contributed to the Dallas Civic Theatre, which opened under the direction of Margo Jones as Theatre ‘47. He was also an early contributor to the Dallas Art Museum.

large 501(c)(3)s can spend a lot on lobbying. Real ambiguity exists as to where a nonprofit’s sanctioned function of “public education” crosses the line and becomes “political campaigning.”

Another type of nonprofit, the 501(c)(4), was created specifically for social-welfare and local employees’ associations devoted to charity, recreation, or education. Some 501(c)(3)s involved in public education are also affiliated with a corresponding 501(c)(4). Some PACS are organized as 501(c)(4)s. Donations to 501(c)(4)s are not tax deductible. The distinctions and inter-workings between 501(c)(4)s, 527s, and PACS are complicated. In practice, they work together.

## Should You Start a Nonprofit?

Many nonprofits are part-time projects. If you’re looking for a way to pay the mortgage, you’re probably better off sticking with a traditional business. Nonprofits, by definition, don’t exist for the benefit of individuals, or individual families; nonprofits exist primarily for the benefit of the community. However, if you are truly committed to an activity that benefits the community, perhaps something that can’t be realized as a for-profit business, then a nonprofit may be just what you’re looking for.

Many people make good money working for nonprofits. But nonprofit work is not for everybody. Salaries are almost always lower than in for-profit businesses. And nonprofits are often bureaucratic: all decisions have to be approved by a board. You may find that you’re beholden to your top donors. Many nonprofits aren’t run, and don’t function, like normal businesses. As a worker, you should be prepared to take up any slack. On the other hand, nonprofit work can be ideal for students and people seeking practical job experience. Many nonprofits sponsor interns.

Incorporating a nonprofit is a way to show potential investors that you’re committed to your cause, however specialized or challenging it may be. You’re not going to shut down your operation and open a coffee shop in its place to run out your lease just because you got hit with a couple of lousy quarters. The process of incorporating involves a lot of

paperwork, including a written statement of your organization's purpose. Ask to see the business plan, articles of incorporation, and IRS Form 1023 of a similar nonprofit. Rob Seible's group adapted its bylaws from those of similar nonprofits. Depending on the organization's expected revenues, it costs either \$400 or \$850 to file IRS Form 1023, the application for IRS recognition of a 501(c)(3).

### L3Cs, Benefit Corps, and Hybrids

The relationships between nonprofits, for-profits, governments, and the communities they serve are still evolving. Low-profit limited-liability companies (L3Cs) are an alternative business type to traditional "C-type" and "S-type" corporations. L3Cs are for-profit businesses run as "social enterprises."

Private foundations like the Gates Foundation regularly make program-related investments (PRIs) in outside organizations, because by law foundations must distribute 5 percent of their assets each year. The problem for foundations is determining which organizations qualify for PRIs under IRS rules. Current IRS rules on the subject are vague enough that nonprofits often must consult their lawyers before making PRIs. The IRS has recently proposed rules that would clarify what qualifies as

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a PRI. L3Cs are intended to create a safe means for large nonprofits to invest in companies performing work that the nonprofits support. So far, nine states and two Native American tribes recognize this sort of company. Legislation on L3Cs is pending in other states as well.

Benefit corporations are another type of "for-profit charity." Benefit corporations are legally recognized in 11 states and are under consideration in numerous others, including Texas. Benefits corporations differ from C- and S-types in how they define "fiduciary responsibility."

The concept of "fiduciary responsibility," as it relates to corporations, has changed drastically since the country's early days. Remember, corporations used to be considered public agencies, meaning that the public's interests were represented in all aspects of corporate governance. We forget that in early America, corporations were tightly regulated. It was

common for states to revoke corporate charters—just shut them down—for any perceived infraction. Today, most corporate officers understand "fiduciary responsibility" to simply mean maximizing profits for shareholders in the shortest time possible.

Advocates for benefit corporations argue that they represent a return to this country's original understanding of what fiduciary responsibilities entail. Benefit corporations and L3Cs are examples of hybrid organizations, for-profit companies that take into account how their actions affect their employees, the environment, and society as a whole. Hybrid organizations are likely to gain popularity as investors seek opportunities for more socially responsible investments. **N**

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