



“Not for Profit” and “Tax Exempt” Misconceptions Debunked

“Not for profit” and “tax exempt” are legal descriptions that don’t necessarily mean what you think they do. Profit, is simply defined as a financial gain, or the difference between the amount earned from the sale of goods or services and the cost of producing such goods or services. Not for profit companies (“NFP”), can not only make a profit, but should actually strive to be profitable or at least maintain a level of revenue, grants and/or donations that allows the NFP to be sustainable. NFPs that are unable to generate sufficient revenues to cover their expenses of operation, will be unable to support their missions. The key to being NFP is that except for reasonable compensation, the NFP’s profits cannot be distributed to the individuals who formed or operate the NFP or for any other private benefit. Rather, the profits generated by the NFP, and the grants and donations it receives, must be used to benefit the community or cause for which the NFP was formed.

NFPs are formed under state law to be charitable or non-charitable. A charitable entity under NYS Not for Profit Corporation Law Section 102(3-b) and (9-a) is an entity formed for “charitable, educational, religious, scientific, literary, cultural or for the prevention of cruelty to children or animals” and non charitable entities under NYS law are formed for non-pecuniary purposes including “civic, patriotic, political, social, fraternal, athletic, agricultural, horticultural or animal husbandry, or for the purpose of operating a professional, commercial, industrial, trade or service association.” NFPs are generally described as mission driven, unlike general business companies whose purposes include anything that a corporation is legally permitted to do. NFPs generally focus on a specific charitable purpose such as universities whose purpose is educational, museums whose purpose is cultural/educational, hospitals whose purposes include education/charitable care/scientific research, chambers of commerce whose purpose is to promote the interests of businesses in a designated geographic area, veterans groups whose purpose is to advocate and/or provide access to benefits and resources to veterans, etc.

“Not for profit” is a status granted by the State, whereas tax exemption is granted by the Federal government. Being “not for profit” does not automatically mean that the entity is also tax-exempt. In order to be tax exempt, the NFP has to obtain tax exemption from the federal government by having a form 1023 application for tax exemption approved by the Internal Revenue Service. In order to be granted tax exempt status, the NFP must have been formed for an “exempt purpose” under the Internal Revenue Code Section 501(c)(3), which include “religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals” no part of the net earnings of which inures to the benefit of any private shareholder or individual, no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation (except as otherwise provided in subsection (h)), and which does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of (or in opposition to) any candidate for public office”.

While tax-exempt organizations enjoy broad exemptions from federal and state taxes such as income tax and sales tax, it is important to understand that tax-exempt organizations have some obligations to pay certain taxes. Tax-exempt organizations, like any other employer, must pay payroll taxes. In order to be relieved from having to pay real property taxes on real property owned by a tax-exempt corporation, the tax-exempt corporation must apply to the real property taxing authority to have the property removed from the tax rolls. However, for that application to be approved, the real property must be used exclusively for charitable purposes. In addition to the foregoing, a tax-exempt corporation that engages in certain commercial activities to generate revenue will incur unrelated business income tax. Unrelated business includes activities such as operating a gift shop or, under certain circumstances, renting out space in the tax-exempt entity's facilities. A tax-exempt entity that fails to comply with its tax obligations puts itself at risk of jeopardizing its tax exempt status.

It is important to understand the limits of the not for profit corporations law and tax obligations of NFPs and tax-exempt organizations. Prior to forming a Not For Profit corporation that intends to obtain tax exempt status, competent legal and tax advisors should be consulted. At RMF, we provide you with informed, experienced and confident legal advisors to help navigate these issues.

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