

Nonprofit vs. Tax-Exempt

When you visit your lawyer or C.P.A, do you feel like you have entered a foreign land where people speak in ambiguous terms and obscure numerical references? If so, you have experienced the mind numbing qualities of nonprofit and charity law jargon. Those of us who practice nonprofit law are all guilty of it. To pay my debt to society, I will attempt to demystify a bit of nonprofit law jargon. I welcome feedback regarding the clarity of the explanation.

Nonprofit vs. Tax-Exempt.

Nonprofit. The designation of an organization as “nonprofit” or “for profit” is a concept of state law. Under state law, for profit organizations are created to make money for their owners and investors. Designating an organization as "nonprofit" only means that the organization is created for some purpose other than making a profit for owners or investors, but not necessarily for a purpose that would qualify it for exemption from taxes. For more about how to form a nonprofit under state law, see another post on [starting a nonprofit](#).

Tax-Exempt. Designation of an organization as "nonprofit" under state law does not mean the organization is also "tax-exempt". With few exceptions, organizations must apply to the IRS for a determination of tax-exempt status. There are numerous types of organizations that qualify for various tax exemptions including exemptions from tax on income that is earned in the course of conducting activities related to the organization's tax-exempt purpose. The most common type of tax-exempt organization is a 501(c)(3) organization. To qualify as a 501(c)(3) organization, the organization must apply to the IRS on Form 1023. Some states also require nonprofits to submit an application to the state to qualify for exemption from state income tax as well as various other state taxes. For more information about the process of applying for tax-exempt status, see my post on [applying for tax-exempt status](#).

Both Nonprofits and Tax-Exempts Can Make Money. This seems so obvious, but I get at least one call a year to settle an argument about whether all the organization's money has to be spent by the end of the year. Really! So, just to be clear, the designation of an organization as "nonprofit" or "tax-exempt" does not mean that the organization can't have money left over in its bank accounts at the end of the year. Money that is not required to meet current expenses should be used to further the organization's mission or can be set-aside as a reserve to cover future expenses.