



Andrew Carnegie's "Gospel of Wealth" articulated the distinction between charity and philanthropy and influenced America's tradition of giving.

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## Chapter Outline

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## Overview of the Nonprofit Sector

America's nonprofit sector is large, complex, and diverse, including organizations very different from one another in purpose, size, and other characteristics. As J. G. Simon wrote in 1987, "The sprawling and unruly collection of animals that populate the nonprofit world—from churches to civil rights groups to garden clubs to the National Council on Philanthropy—makes this field hard to grasp and study all at once" (p. 69). And, as we will soon discover, the nonprofit sector is even more sprawling and unruly today than it was in 1987.

In this chapter, we will look at the nonprofit sector as a whole and establish basic concepts and definitions that will help bring some order to our understanding of its structure, boundaries, and characteristics. Let's start by taking a brief imaginary tour around one American city, starting from the author's office on the campus of the George Washington University, located in the Foggy Bottom neighborhood of Washington, DC, near the White House. As the nation's capital, Washington, DC, is home to a significant number of nonprofits, but the variety of organizations that we will see on our tour is typical of what we might find in many American cities. A walk through this one city helps give us a sense of the complexity to be found in today's nonprofit sector all across the country.

Leaving the author's office at the university, we might walk past the George Washington University Hospital, then turn down the street and pass Western Presbyterian Church, just a few blocks from the edge of campus. We might see men and women waiting to enter the basement of the church to visit Miriam's Kitchen, an organization that provides food and services to homeless people and works to end chronic homelessness.

If we take another turn, we would walk past the headquarters of the National Park Service and then in front of the national headquarters of the American Red Cross. Proceeding farther into town, we would see the headquarters of the National Geographic Society. Eventually, we might walk past the Smithsonian Institution, located in several buildings along the National Mall, which extends from the Washington Monument to the Capitol building. If we walked a loop around the Capitol, we would pass the massive buildings of the Library of Congress. Walking back toward campus over Massachusetts Avenue, we would pass the headquarters of the Cato Institute

### Learning Objectives

After reading this chapter, students should be able to

1. Identify various types of nonprofit organizations.
2. Explain the historical growth of the nonprofit sector.
3. Compare various terms used to identify the nonprofit sector and explain their implications.
4. Classify nonprofit organizations according to the National Taxonomy of Exempt Entities and the Internal Revenue Code.
5. Explain the differences between organizations classified under 501(c)(3) and 501(c)(4) and the advantages and limitations related to each classification.
6. Explain differences among charitable subsectors.
7. Classify organizations as purely philanthropic, purely commercial, or hybrid, depending on various characteristics.
8. Explain new organizational forms and the concept of the fourth sector.
9. Analyze cases, applying concepts from the chapter.

and the Brookings Institution, both public policy think tanks. Depending on our route, we might see the Phillips Collection, which is an art gallery; the Urban Institute; and Anderson House, home to the Society of the Cincinnati, which promotes interest in the Revolutionary War. Arriving back at the George Washington University, we would be tired—it would have been a long walk. Thankfully, there are a number of Starbucks nearby, so we could sit down for a cup of coffee and rest. We might be thinking about the various sights we have seen in our day and trying to identify which are nonprofits and which are not. That would not be as easy a task as it might initially seem.

We would indeed have encountered a number of nonprofits on our tour, but some may seem more nonprofit-like than others. When the word nonprofit is used, many people think first of an organization like Miriam's Kitchen. While it is located in Western Presbyterian Church, it is a separate organization. It is small and supported mostly by charitable gifts. Its workforce includes many volunteers, and it provides its services to people who pay nothing for them. Most people also probably recognize the American Red Cross as a nonprofit organization, which it is, although it is chartered by the U.S. Congress and has a mandate from government to provide services to the U.S. military and to the general population in times of disaster. Some may not think of Western Presbyterian Church or other religious congregations as nonprofits in the same way they think of the Red Cross or Miriam's Kitchen, but religious congregations are indeed a part of the nonprofit sector. So are many art galleries, such as the Phillips; research organizations, such as Brookings, Cato, and the Urban Institute; and many fraternal organizations, such as the Society of the Cincinnati.

Some organizations may seem like nonprofits, but the reality is more complex. For example, the George Washington University Hospital, which we would have passed early on in our walk, doesn't seem any different from other hospitals that are nonprofit. But it is in fact a for-profit hospital owned jointly by the George Washington University (a nonprofit institution) and Universal Health Services (a for-profit hospital management corporation). Although the hospital is right down the street from Miriam's Kitchen and provides services to some of Miriam's clients, as an organization, it is really more like Microsoft than Miriam's.

Some organizations display combinations of nonprofit missions and business operations. Our imaginary tour of Washington, DC, touched two of these—the Smithsonian and National Geographic. The National Geographic Society is a nonprofit organization dedicated to geographic exploration and education. But National Geographic Partners is a for-profit company that controls the iconic *National Geographic* magazine and various media entities bearing the National Geographic name. Since 2019, this for-profit business has been jointly owned by the National Geographic Society and Disney (Littleton, 2019). The National Geographic Society remains a nonprofit organization with its historic mission of exploration and education. (The National Geographic Society is discussed in more detail in Case 14.1 in this text.)

The Smithsonian Institution is a national museum, and many people may think of it as a government agency. But it is a complex organization, operating in part like a government agency, in part like a nonprofit organization, and in part like an entrepreneurial business. The Smithsonian receives a significant portion of its support from federal appropriations, but it was founded through a charitable bequest from James Smithson, after whom it was named, and it actively solicits philanthropic gifts. A separate nonprofit division, called Smithsonian Enterprises, manages the business activities of the Smithsonian Institution, including retail stores, a mail-order catalogue, product development and licensing, magazine publishing, an educational travel program, theaters, restaurants and other concessions, business partnerships for book publishing, and the Smithsonian TV channel. Some staff members at the Smithsonian are federal government employees while others are supported by private sources of revenue (Smithsonian Institution, n.d.).

If the line between nonprofit organizations and for-profit businesses is sometimes difficult to distinguish, the line between the nonprofit sector and government itself is also increasingly blurry. One third of the revenue of **charitable nonprofits** (33 percent) comes from

government grants and payments for services under programs such as Medicare and Medicaid (Independent Sector, 2016a). Some nonprofit organizations exist primarily as government contractors implementing government-funded programs. However, some government agencies also have begun to tap the private sector for support to supplement the funds they receive from tax revenues, including two we passed on our journey around Washington, DC—the National Park Service and the Library of Congress. Both are agencies of the federal government that are increasing their efforts to raise private funds to supplement government appropriations.

Some relationships engage all three sectors. For example, car manufacturer Subaru, a corporation, contributes vehicles to the National Park Foundation, a nonprofit organization, for use in the parks managed by the National Park Service, a government agency (Subaru of America, 2016). Further confusing the landscape, there are for-profit companies that look, feel, and sometimes sound nonprofit-like in the way they describe their missions, programs, and goals. Some compete directly with nonprofits engaged in similar activities. Consider, for example, the three goals articulated by one organization: “helping government, serving people, improving outcomes.” That sounds like the description of a nonprofit organization’s goals, but it is indeed drawn from the website of MAXIMUS, a large for-profit corporation that manages government programs and maintains offices in various locations around the world (MAXIMUS, 2019).

Clearly the lines between the for-profit, nonprofit, and public sectors of our society are sometimes difficult to perceive without close examination. As we will discuss later in this chapter, some have indeed become hybrids that operate in more than one sector at once. The popular image of a nonprofit organization as a small band of volunteers intending to do good, working with minimal resources, serving people in need, and sharply distinct from business and government is far from the reality of many nonprofit organizations today. To understand how we came to where we are and make sense of the “sprawling and unruly collection of animals” that is today’s nonprofit sector, we will need some understanding of the history that brought us to this point—and perhaps some road maps to lead us through the “zoo” (J. G. Simon, 1987).

## America’s Nonprofit Sector: A Historical Overview

The roots of America’s nonprofit sector lie in the ancient traditions of charity, philanthropy, and voluntarism. Virtually all cultures and religions include some emphasis on the importance of service to others, which includes giving or voluntary action. Kevin Robbins (2012) traces the origins of these traditions in the Western world to early Greek, Roman, and Judeo-Christian thinking.

The legal foundations of America’s nonprofit sector are drawn from English law, particularly the Statute of Charitable Uses and the Poor Law, both passed in 1601. These laws clarified the relationship between the British government and the Church of England, defined the legitimate activities to be supported by charity, and established a means to make the trustees of charitable institutions accountable (Hammack, 1998). The philosophy reflected in these statutes influenced the development of U.S. law regarding nonprofits and is still reflected in American legal traditions.

Although their roots are ancient, it is in the United States that the traditions of charity, philanthropy, and voluntarism have reached their most elaborated expression. As early as 1835, the Frenchman Alexis de Tocqueville observed the unique propensity of Americans to form “voluntary associations” to address social and political objectives, which he reported in his famous book *Democracy in America* (1838). Indeed, in a young nation born in revolution against the authority of the British government, voluntary organizations and institutions provided many of the services, from schools to volunteer fire departments. A certain mistrust

of government has been a pervasive and continuing aspect of American culture and has provided philosophical support for private, voluntary initiatives throughout the nation's history. As we saw in our tour of Washington, DC, there appears to be some blurring of the nonprofit sector and government in today's environment. But it is important to recognize that the blur was even greater in the earliest days of the nation, when government supported churches, and churches sponsored many of the young institutions that served communities.

The beginnings of our modern nonprofit sector lie in the early years of the 20th century. Amid the rise of great wealth resulting from the Industrial Revolution, charity and philanthropy became organized activities undertaken on a large scale. This was the time of great philanthropists such as John D. Rockefeller and Andrew Carnegie, who endowed universities, libraries, colleges, and other institutions across the nation. Carnegie's essay, popularly known as the "Gospel of Wealth," published in 1889, remains a classic statement of the philosophy underpinning the American tradition of philanthropy. Carnegie expresses the responsibility of wealthy individuals to give back to the society that has enabled their accumulation of wealth, saying, "The man who dies thus rich dies disgraced" (p. 664). Carnegie's philosophy remains deeply a part of American culture, as evidenced by many contemporary entrepreneurs and investors, such as Bill Gates and Warren Buffett, who have created charitable foundations with similar expressions of obligation. Indeed, Gates and Buffet were leaders in promoting the Giving Pledge, a commitment by some of the world's wealthiest people to use the majority of their wealth to give back to society. By 2019, the pledge had been signed by 204 individuals (Giving Pledge, 2019).

Carnegie also helped establish a distinction between the concepts of charity and philanthropy. Although the words are often used interchangeably, and philanthropy is sometimes used as the broader, encompassing term, they describe two different types of giving. **Charity** is appropriately defined as giving intended to meet current individual human needs or to alleviate current human suffering—for example, to feed the homeless or aid the victims of a natural disaster. It is emotionally driven and often impulsive, as evidenced by the outpouring of gifts made through the mail, by phone, and online within days of any natural disaster, such as Hurricanes Michael and Florence in 2018, as well as the deadly Camp Fire in California that same year. The website GoFundMe (<https://www.gofundme.com>) provides a vehicle for individuals to respond to the critical needs of specific individuals, reflecting similarly charitable motivations.

**Philanthropy**, on the other hand, is a more rational form of long-term investment in the infrastructure of society, seen, for example, in gifts made to construct new hospitals, endow universities, or create new charitable foundations intended to exist in perpetuity. If the goals of philanthropists are ultimately achieved, it is arguable that the need for charity will be eliminated since there will exist institutions prepared to meet any human needs that may arise. However, in the imperfect world of the present, both types of giving are important and complementary in their impacts.

Some writers, notably Robert Payton (1988), have defined philanthropy to encompass **voluntarism** (also called *volunteerism*), calling philanthropy "voluntary action for the public good." But most people would make a distinction. Philanthropy could involve giving money from afar while having little or no involvement with the organization or its beneficiaries, but volunteering implies a more hands-on role.

Notwithstanding the ancient roots and long history of charity and philanthropy in the United States, the concept of a definable nonprofit sector, comparable with the for-profit and governmental sectors, is of relatively recent origin. It dates to the work of the Commission on Private Philanthropy and Public Needs (the Filer Commission, mentioned in Chapter 1) from 1973 to 1975. The commission's 1975 report, titled *Giving in America*, was the first to characterize nonprofits as constituting a recognizable sector of society. The Filer Commission report came at a time when the nonprofit sector was expanding, in part reflecting changes in government policy. The 1960s and early 1970s were a period of increasing government spending on social programs, starting with the Great Society programs of President Lyndon B. Johnson. In

many cases, government funds were channeled to nonprofit organizations, which provided the actual services. “Indeed,” Lester Salamon (2012b) observes, “much of the modern nonprofit sector as we know it took shape during this period as a direct outcome of expanded government support” (p. 22). In the 1980s, under President Ronald Reagan, federal spending for many social programs was sharply reduced. Since the 1980s, there also has been a change in the form in which federal support is provided, with important implications for the management of nonprofit organizations. The shift has been away from direct grants to nonprofit organizations and toward providing aid to individuals in the form of voucher-type subsidies. This occurred, for example, in health care, where Medicare and Medicaid reshaped the industry. And it also occurred in higher education, where government funds going directly to colleges and universities diminished while aid directed to individual students and their families increased. This created a new generation of student consumers and transformed higher education institutions into competitive, marketing organizations. The shift was also illustrated in the welfare reform legislation of 1996, which brought competition to many areas of human services. This empowerment of individuals as consumers through direct subsidies to them has forced nonprofits to compete for customer dollars not only with other nonprofits but also with for-profit companies that have entered fields that were previously the exclusive preserve of the nonprofit sector. For example, the for-profit firm MAXIMUS, mentioned previously, is now among the nation’s largest managers of Medicaid and the Children’s Health Insurance Program. Future changes in government funding, in both scale and method, are always possible and would have an inescapable impact on the nonprofit sector.

Changes in government funding also account in part for the growing commercialization of the nonprofit sector itself, the increased need for professional nonprofit management, and the demands that nonprofits demonstrate greater accountability and results. Nonprofit organizations comprise a vital and growing sector of our economy and society, but questions about their effectiveness and accountability are topics of national discussion and debate. There are even occasional challenges to the tax exemption of nonprofits, especially those that are highly commercialized.

## Searching for a Common Vocabulary

The nonprofit sector is so diverse and its structure is so complex that it can be confusing, and there are various ways in which people understand it. Diverse understandings are reflected in the fact that there are multiple terms by which the sector is identified.

As Thomas Wolf (1999) points out, describing an elephant as a “non-horse” would seem to most people an unsatisfactory definition (p. 19). But the term *nonprofit organization* really refers to one thing nonprofit organizations do not do, rather than capturing much about what they are or the diverse programs and services they offer to society. One thing nonprofit organizations do *not* do is distribute profits to individual owners in the form of dividends or use those profits to enhance the wealth of owners through the increasing value of the enterprise.

However, it is important to dispel any misunderstanding that nonprofits cannot earn profits. Nonprofits can and do earn profits, but these are defined as simply an excess of revenues over expenses. Indeed, one well-known study (Chang & Tuckman, 1990) found that, contrary to what many theories might predict, nonprofit managers do try to earn profits and build up the assets of their organizations. But these profits must be retained within the organization and eventually used to further its programs rather than enrich individuals personally. Unlike corporations, nonprofits cannot distribute their profits to individuals in the form of dividends. This prohibition against the distribution of profits, also called the **nondistribution constraint**, is one defining characteristic of nonprofit organizations, but it is clearly not *the* defining characteristic. Indeed, by this narrow standard, the Department of Defense and

the state of New York might be called “nonprofits,” since they also have no stockholders or owners to whom any profit is distributed.

While the term *nonprofit organization* or just *nonprofit* is the most commonly used term for these organizations in the United States, those nonprofits that work internationally are generally known as **nongovernmental organizations**, although there is no identifiable nongovernmental sector with the same meaning as the term *nonprofit sector* in the United States. The term *nongovernmental* is one that originated with the United Nations and reflects in part the reality that many such organizations are performing government-like functions in the countries they serve and that most receive a substantial portion of their revenue from government sources. Many are like arms of government operating just outside the public sphere. Like *nonprofit*, the term *nongovernmental* defines organizations by what they are *not*—they are not government agencies. But this term seems equally inadequate. It could apply as well to profit-making companies such as Google and Amazon, which are also clearly nongovernmental in their ownership and legal control.

## Alternatives to Nonprofit

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While *nonprofit* is the term most commonly used to describe the sector, there is no shortage of alternatives that some people employ. Each alternative has its own virtues, and shortcomings as well. It is worth examining those terms in order to understand the different views and perspectives that they reflect.

The term **independent sector** has some prominence since it is also the name of the principal organization representing the interests of nonprofits in Washington, DC—Independent Sector ([www.independentsector.org](http://www.independentsector.org)). But the term itself raises the question of “independent from what?” Nonprofits are financially dependent on resources derived from both government and private donors and are subject to an increasing array of state and federal law, so independence would not seem to capture their essence.

Some prefer the term **third sector**, placing nonprofits in the universe alongside the commercial economy and government. The term is accurate in terms of size—both the business sector and government employ more people, generate larger revenues, and account for a larger share of economic output. But it also seems to imply a rank order of importance, which would not agree with the values of many people, who may consider religion, education, the arts, medical research, and other purposes served by the nonprofit sector to be among the most important of human endeavors. Furthermore, some scholars suggest that American society encompasses not three but four sectors: business, government, the nonprofit sector, and families and communities. In this broader array, it becomes more difficult to rank the sectors, except by size, in which case families and communities would come first and the nonprofit sector would be fourth rather than third.

The term **charitable sector** is sometimes used, but it is contrary to the reality that charitable gifts, while important, are not the largest source of nonprofit revenues. Nor is the term synonymous with *nonprofit sector*, since there are organizations that qualify as nonprofit under the U.S. tax code but that neither seek nor receive any form of charitable support. This is true, for example, of membership organizations that are funded entirely through dues and those nonprofits whose revenues may consist entirely of grants and contracts received from government. Nor does the term seem appropriate to encompass major institutions, such as Harvard University, that are nonprofit but hardly consistent with most people’s understanding of a charity.

Some use the term **voluntary sector**. Indeed, that term is part of the title of one of the leading academic journals in the field, *Nonprofit and Voluntary Sector Quarterly*. Voluntarism is one of the foundations of the sector, and many organizations do indeed rely on volunteers,

both as members of their governing boards and for at least part of their workforce. But the term does not reflect the reality that, in many nonprofits, paid staff members far outnumber volunteers. It also may perpetuate an inaccurate image of nonprofits as universally small and amateurish in their operations, when in fact many nonprofits are substantial enterprises, and professional management of nonprofits has been a growing trend.

The phrase **tax-exempt sector**, commonly used by accountants, attorneys, and other tax specialists, is similar to *nonprofit*. It identifies organizations entirely in terms of their status under U.S. tax law. With a few exceptions, nonprofits are exempt from paying federal income tax and generally from state and local income taxes as well. But, again, the term *tax-exempt* speaks to the legal status of such organizations and says nothing about what they actually do. As we will discuss shortly, the sector encompasses a variety of organizations with few apparent similarities aside from their tax-exempt status.<sup>1,2</sup>

Another term that has been proposed is **civil society sector** (Salamon, 2012a). There are many different definitions of civil society, and while “the nonprofit sector provides the organizational infrastructure of civil society,” the concept itself is more abstract, including “the sum of institutions, organizations, and individuals located between the family, the state, and the market, in which people associate voluntarily to advance common interests” (Anheier, 2014, p. 9). And as Salamon (2012a) acknowledges, the term *civil society sector* is like *voluntary sector* in that it “emphasizes the citizen base” of these organizations, while most are not membership associations and many engage large paid staffs (p. 13).

In recent decades, nonprofits have come to be increasingly managed like businesses, and some undertake entrepreneurial ventures either directly, through for-profit subsidiaries, or with for-profit partners. Some people have adopted the term **social enterprise** to encompass nonprofits that have a social objective but employ commercial principles in their generation of revenue (Social Enterprise Alliance, 2019). Although the term *social enterprise* is generally associated with those who especially advocate organizations operating like businesses and undertaking efforts to increase revenues from commercial activities, it could be argued that the term captures the positive essence of *all* private organizations having a social purpose, perhaps better than *nonprofit*. Like companies, nonprofits bring together people, resources, and purposeful effort in pursuit of a mission, and they increasingly operate with plans, goals, and established criteria for success—they are indeed enterprises. But their missions relate to social purposes rather than to the enrichment of private individuals. Were *social enterprise* to become a general designation for all such organizations, the sector that contains them perhaps then would be called the **social sector** to differentiate it from business and government. That term is indeed used by some people, but it has not gained universal acceptance and the more common designations of nonprofit organization and nonprofit sector are generally used in this book.

Noting the increasing number of organizations that operate under both nonprofit and for-profit legal forms, often called **hybrid organizations**, some authors have suggested that there may be an emerging **fourth sector**, encompassing organizations that blend the features and methods of both forms (Fourth Sector Group, n.d.). Some new types of organizations have developed in alignment with this concept of the fourth sector, which will be discussed further later in this chapter. (This use of the term *fourth sector* should not be confused with the concept discussed earlier in which families and communities are considered a fourth sector of society in addition to business, government, and nonprofits.)

## Size of the U.S. Nonprofit Sector

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There are more than 1.5 million tax-exempt organizations in the United States that are registered with the Internal Revenue Service. That does not include all religious congregations or smaller organizations that are not registered; if they were included, the total number



would be larger (McKeever, 2018). These organizations serve a wide range of purposes. Some are “public-serving” and others are “member-serving,” terms that will be explained further later (Salamon, 2012b, p. 7). The largest group is the charitable nonprofits, classified under 501(c)(3) of the Internal Revenue Code, numbering approximately one million (McKeever, 2018). Those include many of the public-serving organizations that we all know—hospitals, museums, schools, colleges and universities, orchestras, youth organizations, and nonprofits that provide a range of human and social services. Another significant number, about 84,000, includes those classified under section 501(c)(4) of the tax code (McKeever et al., 2016, p. 3). This section of the tax code does include some large organizations that are health maintenance organizations (HMOs) or managed health plans, but the most well-known organizations in this category are distinguished by their advocacy on issues, for example, the National Association for the Advancement of Colored People (NAACP), the National Rifle Association (NRA), and the Sierra Club.

The nonprofit sector is a significant component of the U.S. economy. In 2016, nonprofits employed 12.3 million people, over 10 percent of the private workforce in the United States. That totals twice as many jobs as the nation’s transportation, wholesale, and finance industries (Salamon and Newhouse, 2019, p. 5). The sector paid over \$638 billion in wages in 2016, which is 30 percent more than the retail industry and 60 percent more than the construction industry (Salamon and Newhouse, 2019, p. 7). Thus, the nonprofit sector has a substantial economic impact.

The nonprofit sector has grown dramatically in recent decades. Sixty-four percent of all public charities were created since 1990 (McKeever et al., 2016, p. 157). From 2000 to 2013, the number of employees in the nonprofit sector increased by 23 percent, compared with 5 percent growth in government and less than 1 percent in business (McKeever et al., 2016, p. 29). The growth is attributable to a variety of forces. As discussed above, they include the trend that began in the 1980s toward the devolution of federal programs to state and local governments and outsourcing of the provision of many services to nonprofits by governments at all levels, as well as increased philanthropy. In addition, some argue, the growth of nonprofits has been fueled by a reawakening of the spirit of public service among the current generation of Americans. Events such as the attacks of September 11, 2001, and large-scale natural disasters, both in the United States and elsewhere over the past two decades, have called the nation’s attention to human needs and the role of nonprofit organizations in helping to alleviate human suffering. Increased and rapid communication has also raised awareness of human conditions and events on a global basis. The requirement of community service for graduation from high school has exposed a generation of young people to the idea of volunteering. Many companies also organize volunteer activities for their employees, extending the experience to more Americans and making it even more a part of American culture.

In his influential, though controversial, 1995 article, “Bowling Alone: America’s Declining Social Capital,” Robert Putnam discussed a decline in civic engagement among Americans, using the metaphor of his title to suggest that Americans were becoming more isolated and more involved in individual pursuits than in collective interests and activities. Yet a decade later, Putnam and his colleague Thomas Sander reported that young Americans who witnessed the events of September 11, 2001, in their adolescent years appeared to be more involved in public affairs and community life than their older siblings. As Sander and Putnam (2005) note, “We’ll have to wait some years to see if this budding civic engagement blossoms, but it could prove to be the largest civic shift in the past half-century” (p. A23). It will still require time to identify what the long-term trends may be, but there is some evidence that millennials do value volunteering more than some previous generations (“More Millennials Value Volunteering,” 2015). In 2017, more than 77 million Americans volunteered, providing services that were estimated to be worth \$167 billion (“Volunteer Hours Now Worth,” 2018). Trends in volunteering are discussed in further detail in Chapter 9 of this text.

## Differentiating the Nonprofit Sector

As we saw from our imaginary walking tour of Washington, DC, nonprofits are a widely diverse group of organizations and institutions. Fortunately, there are ways of bringing order out of the apparent chaos by placing nonprofits into categories. Let's review some of them and see if we can gain a clearer picture of this complex arena. We will look at two ways of categorizing nonprofits according to their purposes and activities (the National Taxonomy of Exempt Entities and the Internal Revenue Service classifications); one model that categorizes nonprofits according to who benefits from their activities (public serving and member serving); and another that places nonprofits along a continuum according to the degree they are commercialized or use business principles and methods.

### National Taxonomy of Exempt Entities

One way to delineate the nonprofit sector is to use the **National Taxonomy of Exempt Entities (NTEE)** Classification System (Jones, 2019). The NTEE divides the universe of nonprofit organizations into 26 major groups under 10 broad categories (Jones, 2019). These categories are based on organizations' purposes, activities, and programs and are similar to the industry classification codes used to group for-profit companies. Box 2.1 lists the 10 broad categories in the NTEE. The complete taxonomy, including subcategories, is available from the National Center for Charitable Statistics (<https://nccs.urban.org/publication/irs-activity-codes>).

Similar ways of classifying nonprofits include the North American Industry Classification System (NAICS), which uses the same breakout as for the for-profit sector. The Bureau of Economic Analysis of the U.S. Department of Commerce and some other agencies use a definition of "nonprofit institutions serving households" (NPISHs), which excludes nonprofits that serve businesses (McKeever et al., 2016, p. 7). The fact that different classification systems are used by various agencies that collect data on the nonprofit sector accounts in part for the fact that estimates of the sector's size and impact are often not consistent. In addition, existing classification systems may provide a somewhat inaccurate picture. For example, one study that analyzed nonprofit mission statements concluded that the NTEE significantly undercounted the number of organizations providing housing and shelter (Fyall et al., 2018).

#### Box 2.1

#### National Taxonomy of Exempt Entities (NTEE) Major Groups

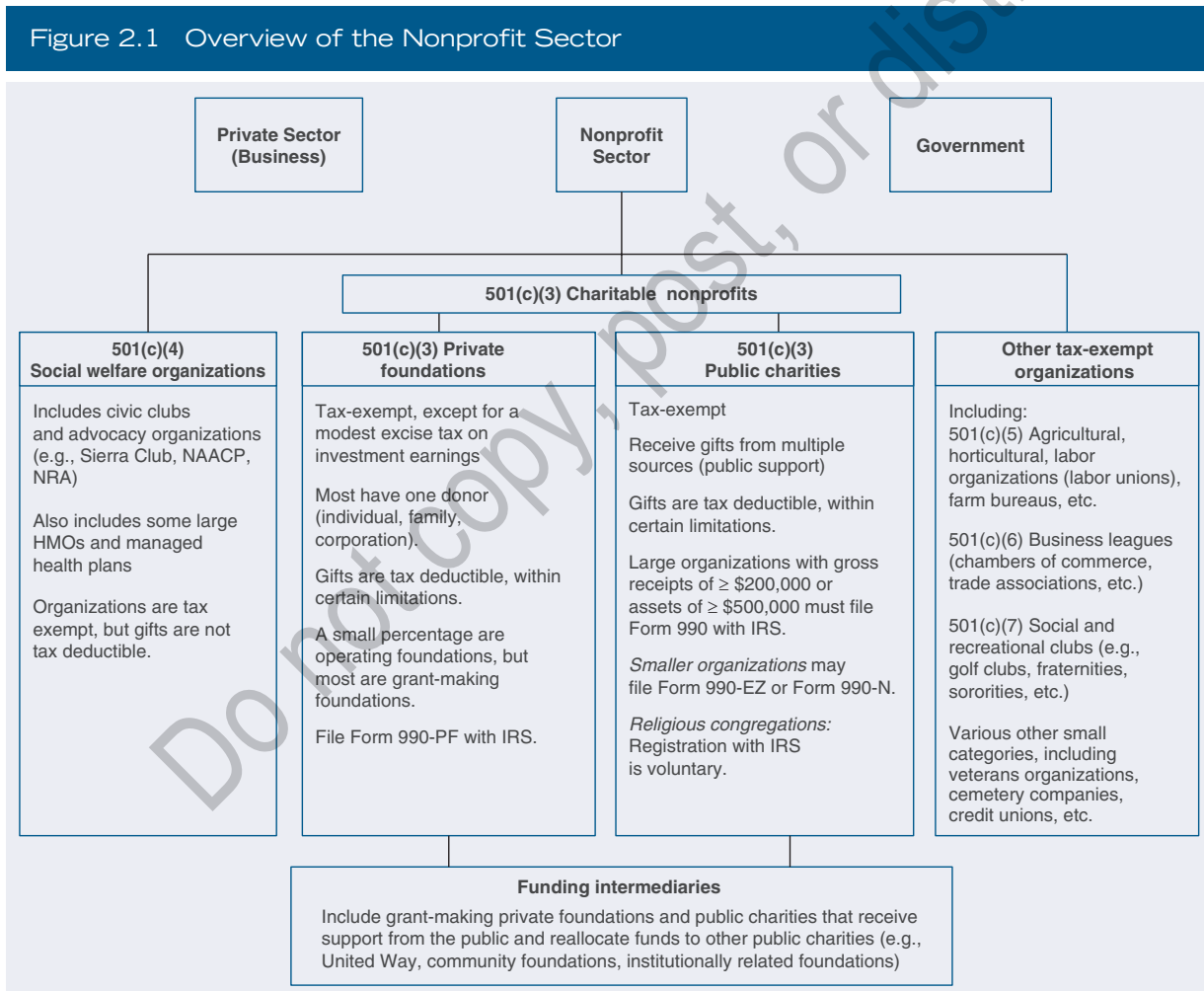
Arts, Culture, and Humanities	International, Foreign Affairs
Education	Public, Society Benefit
Environment and Animals	Religion Related
Health	Mutual/Membership Benefit
Human Services	Unknown/Unclassified

*Source:* National Center for Charitable Statistics (2019).

## IRS Classifications

One of the reasons that there are different definitions of the nonprofit sector is that classifications of organizations are developed with varied purposes. For the Internal Revenue Service (IRS), what is relevant is the exemption of nonprofit organizations from the corporate income tax, so the IRS places nonprofits into more than 30 categories (or “classifications”) that reflect the basis for their tax exemption (McKeever et al., 2016, p. 158). As discussed previously, the very term *nonprofit* relates to the treatment of organizations under the U.S. tax code, so the IRS classifications are perhaps the most often mentioned. Moreover, from a practical perspective, how an organization is classified under the tax code is also of the greatest significance to those who govern and manage it, since this status dictates many of the rules by which the organization must operate. Nonprofits qualify for tax exemption under various sections of the Internal Revenue Code (IRC), depending on the nature of their principal activities.

The tax code can be complicated, as you will know if you have ever filed your own personal tax return. Figure 2.1 provides a way to visualize the nonprofit sector and how various organizations are classified by the IRS. It first divides society into the three sectors:



Source: Based on IRS Publication 557, revised January 2019 (retrieved from [www.irs.gov/pub/irs-pdf/p557.pdf](http://www.irs.gov/pub/irs-pdf/p557.pdf)).

government, nonprofits, and for-profit business. The nonprofit sector then is divided into four categories. The largest category includes organizations that are tax-exempt under Section 501(c)(3). There are two types of organizations in that category: public charities and private foundations. Other organizations are exempt under Section 501(c)(4). They are referred to by the IRS as “social welfare organizations,” encompassing what many would call **advocacy organizations**, as well as others. There are a variety of other tax-exempt organizations, classified under various sections of the tax code, such as labor unions, chambers of commerce, social and recreational clubs, trade associations, and others. While this latter group is tax-exempt, the organizations are not ones we commonly think about when the term *nonprofit* is used. For example, the National Football League (NFL) was tax-exempt as a trade association under Section 501(c)(6) of the IRC, a fact that was controversial until the league voluntarily relinquished its tax exemption in 2015 (Strachan, 2015). Despite the wide array of organizations that are tax-exempt, most are not a focus of the discussion in this chapter or in this book, which emphasizes the charitable [501(c)(3)] and advocacy [501(c)(4)] organizations that most closely align with the conception of the nonprofit sector that most people hold.

Let’s take a closer look at the 501(c)(3) and 501(c)(4) organizations that are the primary types discussed in this book. Although they are fewer in number than the charitable nonprofits, this discussion will start with the 501(c)(4) nonprofits, known to the IRS as **social welfare organizations**. We then will turn to a longer discussion of the charitable nonprofits, which are the largest component of the sector.

## Social Welfare Organizations

There are different types of organizations classified under Section 501(c)(4). A small number are health maintenance organizations (HMOs) and other medical and dental insurance plans, although these account for the major portion of the revenues in the 501(c)(4) category. In this book, we generally ignore those organizations and focus on the vast majority of 501(c)(4)s that are considered advocacy organizations because their purpose is to advance a cause or work for social change.

It is important at this point to distinguish between two concepts: the tax exemption of organizations themselves and the tax deductibility of gifts made to them. *All* nonprofit organizations represented in Figure 2.1 are tax-exempt; that is, they are generally not required to pay federal taxes on their *income*, although some may be subject to other taxes. For example, private foundations pay a tax on their investment earnings and, under federal tax legislation passed in 2017, a small number of colleges and universities are subject to an excise tax on endowment income. Under that same law, some nonprofits may be subject to a tax related to compensation exceeding \$1 million (National Council of Nonprofits, 2019b).

In addition, organizations exempt from federal income tax are usually also granted exemption from state and local income taxes, which increases the benefits attached to this status. However, *only* those classified under Section 501(c)(3)—the charitable nonprofits—are tax-exempt themselves and *also* eligible to receive gifts that are tax deductible for the donors. Thus, the NAACP and the NRA, which are classified under 501(c)(4), are tax-exempt, but gifts made to them are not tax deductible for the donor because the NAACP and NRA are not classified as charitable organizations.

Advocacy organizations are tax-exempt—under Section 501(c)(4)—because they work, in the IRS’s words, “to further the common good and general welfare of the people of a community (such as by bringing about civic betterment and social improvements)” (IRS, 2020c). But they *cannot* receive tax-deductible gifts. Why are advocacy organizations different from charitable nonprofits in the eyes of the tax code? One big difference between 501(c)(3) and 501(c)(4) organizations is that the latter do not face the same limitations on lobbying and political activity that are imposed on the former. They can spend money on lobbying without limitation (IRS, 2020b). This is a point we will discuss in more detail in Chapter 11 of this text.

Because of the different advantages enjoyed and disadvantages experienced by 501(c)(3) and 501(c)(4) organizations, in terms of the tax treatment of gifts and the limitations on lobbying and political activity, some organizations have two arms—actually, two separately incorporated but related organizations. One organization is qualified under Section 501(c)(4) and is free to engage in lobbying without restriction. It cannot receive deductible gifts, but it can raise funds through member dues and others types of revenue, which are not tax deductible. The other related organization is qualified under Section 501(c)(3) and is thus eligible to receive tax-deductible gifts. It pursues education, research, and other activities consistent with that classification.

Box 2.2 provides an example in the form of mission statements for the Sierra Club, an internationally known environmental organization, and the related Sierra Club Foundation. The Sierra Club itself is a 501(c)(4) social welfare organization that works to preserve the environment, including by lobbying for environmental protection legislation. The Sierra Club Foundation is a 501(c)(3) organization that supports certain activities of the Sierra Club and other environmental programs. As its mission statement and description of its activities explain, the foundation works to “educate and empower people,” activities that are consistent with the purposes allowed for 501(c)(3) organizations. Note the slight difference in the mission statement of the Sierra Club—it goes beyond educating and empowering and includes “enlisting” humanity, which suggests the possibility of building political coalitions and encouraging individuals to political action. This may seem like a subtle difference, but facing the possibility of an audit by the IRS and wishing to protect the tax status of both entities, most organizations are precise in monitoring their activities for consistency with tax law.

## Charitable Nonprofits

Now let’s turn to the two boxes shown in the middle of Figure 2.1—the charitable nonprofits that are public charities and the charitable nonprofits that are private foundations, both tax-exempt under Section 501(c)(3). These two groups have some characteristics in common,

### Box 2.2

#### Comparison of Charitable and Social Welfare (Advocacy) Organizations

##### Mission of the Sierra Club, a 501(c)(4) Organization

- To explore, enjoy, and protect the wild places of the earth;
- To practice and promote the responsible use of the earth’s ecosystems and resources;
- To educate and enlist humanity to protect and restore the quality of the natural and human environment; and to use all lawful means to carry out these objectives.

Source: Sierra Club website (<https://www.sierraclub.org/policy>).

##### Mission of the Sierra Club Foundation, a 501(c)(3) Organization

- The Sierra Club Foundation promotes efforts to educate and empower people to protect and improve the natural and human environment.

Source: Sierra Club Foundation website (<https://www.sierraclubfoundation.org/about-tscf/our-values/mission>).

but in other ways, they are different. All charitable nonprofits are not only tax-exempt but are eligible to receive tax-deductible contributions. The tax deductibility of gifts made to charitable nonprofits obviously provides a significant advantage to them in their fundraising efforts.

Consider the example of an individual donor who is in a 25 percent federal tax bracket and who makes a deductible gift of \$100 to a charitable nonprofit organization. He or she deducts that \$100 from his or her income before calculating the income tax due. The donor's taxable income is reduced by \$100, so the donor's tax bill is reduced by 25 percent of that amount, or \$25. This is considered a tax savings because, were it not for the gift, the donor would have paid that amount in additional federal income tax. The out-of-pocket cost of the \$100 gift is thus reduced, from \$100 to \$75 (\$100 minus the \$25 tax savings). Some view the savings as a form of tax subsidy, or tax expenditure, in the form of foregone federal revenue. And, since many states also permit the deduction of charitable gifts, the donor often has an additional savings on taxes at the state level.

The tax deduction for gifts to charitable organizations is intended to encourage charitable giving and sustain the services that such organizations provide. It should not be viewed as a tax loophole because it is intentionally provided in the law as an incentive to giving. Society has determined that the purposes nonprofits serve are to the public benefit and that if the nonprofits did not exist, those services might need to be provided by government. Being eligible to receive deductible gifts makes it easier for charitable nonprofits to raise funds, since the donors are, at least theoretically, able to give more because of the tax saving realized from the deductions. However, federal tax legislation passed in 2017, the Tax Cuts and Jobs Act of 2017, significantly increased the number of taxpayers eligible to claim a standard deduction on their tax returns. They would no longer be able to receive a deduction based on a list of their specific charitable contributions during the tax year. As a result, fewer people may benefit from the deduction of charitable gifts. Following passage of this legislation, some observers predicted that it could have a negative impact on giving, since loss of the deduction would affect the out-of-pocket cost of gifts for many taxpayers. Others argued that the tax law changes would increase incomes, permitting people to give more (Eisenberg, 2019). In reaction to the COVID-19 emergency in 2020, federal legislation was passed to expand tax incentives for charitable contributions by permitting a limited deduction in addition to the standard deduction. This was intended as a temporary provision. At the time of this writing, it is not known whether additional incentives may be extended.

To be recognized as tax-exempt under Section 501(c)(3), an organization must demonstrate three things; in other words, it must meet three tests. First, it must be organized and operated for one or more of eight purposes: charitable, religious, educational, scientific, literary, testing for public safety, fostering national or international amateur sports competitions, and preventing cruelty to children and animals. (Curiously, the IRC does not specifically mention health care, although it is one of the largest components of the nonprofit sector.) The term charitable may seem somewhat imprecise, but the IRS (2020a) defines it to include certain specific activities:

relief of the poor, the distressed, or the underprivileged; advancement of religion; advancement of education or science; erection or maintenance of public buildings, monuments, or works; lessening the burdens of government; lessening neighborhood tensions; eliminating prejudice and discrimination; defending human and civil rights secured by law; and combating community deterioration and juvenile delinquency.

In addition to demonstrating that its primary purposes include one or more of those discussed above, a 501(c)(3) nonprofit must meet two other requirements. It must meet the nondistribution test, ensuring that its assets are not being used to benefit individual owners and that its managers are not being personally enriched through excessive compensation. And it must limit its political activities. A nonprofit that qualifies under Section 501(c)(3) cannot support or oppose candidates for public office, and again, it must limit its expenditures on lobbying—that is, efforts to influence legislation. The prohibition on political

activity by charitable nonprofits derives from the Johnson Amendment, a federal law sponsored by then U.S. Senator Lyndon B. Johnson and passed in 1954. In recent years, some have challenged the law, arguing that it is a restriction on free speech. The issue likely will continue to be debated in the years ahead.

**Charitable Subsectors.** Let's take a look at the major subsectors of the charitable nonprofits, excluding religious congregations. Bear in mind that, as shown in Figure 2.1, religious congregations are charitable nonprofits under the tax code, and they are tax-exempt under Section 501(c)(3). However, as noted before, religion is a unique component of the nonprofit sector. The U.S. Constitution guarantees the separation of church and state, which restricts government power over these organizations. Gifts to religious congregations are tax deductible, but congregations are not required to register with the IRS, although some do so voluntarily. The principle of separation of church and state prevents government funds from going directly to religious congregations or to organizations that would use them for religious activities. However, congregations are to be distinguished from **faith-based organizations** that provide social services. Since they provide services to people beyond the members of their congregations, they can receive government funds to support their secular programs. This book does not specifically discuss the management of religious congregations. Religious organizations are the least professionalized of the subsectors. Although there has been some growth in the number of church managers, the management of most congregations is still done by the clergy and volunteers.

As discussed below, the charitable subsectors differ significantly in their sources of revenue, the degree of commercialization they reflect, and the extent to which their management has been professionalized—that is, the extent to which they are run by paid staff rather than volunteers.

**Arts, Culture, and Humanities.** The arts and culture subsector includes museums, performing arts groups, art galleries, folk-life organizations, nonprofit radio and television stations, literary societies, arts education organizations, media and communications organizations, and arts councils and agencies. In 2013, this subsector accounted for almost 10 percent of charitable nonprofits, but only 2 percent of the sector's expenses (McKeever et al., 2016, p. 190). This sector receives substantial earned income from admission fees, gift shops, and other sources and also receives gifts from individuals, corporations, and foundations. Arts institutions and museums are distinct and unique nonprofits, and the management of each constitutes a specialty area within nonprofit management; professionals often will have attended university programs focused on one of these fields.

**Education.** Education is perhaps the subsector best known to students. It includes colleges and universities; preschool, elementary, and secondary schools; correspondence schools; libraries; parent-teacher groups; and education support organizations. Of course, most educational institutions are not nonprofits; they are entities controlled by state or local governments, including public schools and public universities and colleges.

It will not surprise students to learn that educational institutions receive a significant portion of their revenues from fees for service, including tuition. But anyone who has graduated from a college, university, or independent school knows that such institutions also actively seek gifts from alumni, parents, and other individuals who are affiliated. Educational institutions, and nonprofits with an educational mission, accounted for about 17 percent of the sector in 2013 and for more than 17 percent of all expenditures in the sector. Colleges and universities are among the largest organizations in the education subsector; while they account for just 4 percent of all education nonprofits, their expenditures account for about two thirds of the total for the subsector (McKeever et al., 2016, pp. 196–199). Higher education, in particular, is a field in which professional management has increased in recent decades. While the senior executives of colleges and universities are still predominantly

drawn from the academic ranks, there has been a proliferation of midlevel management in areas such as fundraising, student services, and financial administration. Middle management has grown as colleges and universities have faced increased competitive pressures, greater governmental regulation, and the need to expand revenues through intensified fundraising and student-recruitment programs.

While for-profit education firms—for example, the University of Phoenix—have grown in recent decades, most schools, colleges, and universities remain either nonprofit or government controlled.

**Environment and Animals.** While environmental protection and the welfare of animals are important purposes, organizations working in these fields—including environmental preservation organizations, recycling programs, pollution abatement programs, animal protection organizations, wildlife preservation organizations, and zoos—constitute the smallest charitable subsector, representing only 5 percent of public charities and just 1 percent of the charitable nonprofit sector's expenses (McKeever et al., 2016, p. 201). It is also a subsector that is highly dependent on charitable gifts, with relatively few opportunities to generate income from fees or sales. It is important to note that some organizations advocating for environmental issues and animal protection are 501(c)(4) organizations rather than charitable nonprofits under 501(c)(3). The Sierra Club was mentioned earlier as one example. Such organizations are not included in the totals stated here for this charitable subsector.

**Health.** The health services subsector is the largest component of the overall nonprofit sector if measured by total revenue, expenditures, or the number of employees. It includes hospitals, home health agencies, outpatient clinics, hospice programs, nursing homes, some HMOs, dialysis centers, community health centers, residential treatment programs for emotionally disturbed youth, blood banks, public health organizations, and disease-focused organizations such as the March of Dimes and the American Cancer Society.

The health subsector is huge. While health organizations account for only 13 percent of public charities, they represent nearly 60 percent of the nonprofit sector's total expenses and more than 43 percent of the sector's total assets. In 2013, the health subsector had revenue of a *trillion* dollars, higher than all of the other subsectors combined (McKeever et al., 2016, p. 205).

Health services is the most commercialized of the nonprofit subsectors; in other words, many of the organizations are businesslike in deriving most of their revenue from fees charged for services provided. It also was one of the first subsectors to become professionalized in its management—that is, to develop large paid professional management staffs rather than depend on volunteers. There are many university programs in health care management and public health, and the salaries of many professional managers in the health subsector, especially in hospitals and large medical centers, are comparable to those in private industry. It is also a field in which nonprofits compete with for-profit firms to a significant extent. In some industries—for example, nursing homes—for-profits have captured the major portion of the market. The health services subsector also has seen the conversion of some nonprofits into for-profit entities, including insurance plans, hospitals, and nursing homes.

**Human Services.** Human service nonprofits account for more than one third of all public charities, making it the largest subsector if measured by the number of organizations (McKeever et al., 2016, p. 205). This subsector includes what many people conventionally think about when the term nonprofit is used—organizations that provide job training, legal aid, housing, youth development, disaster assistance, and food distribution programs. But many of these organizations are small; together, they represent only 10 percent of the nonprofit sector's total assets and 13 percent of its total expenses (McKeever et al., 2016,



p. 208). Although many people might consider organizations working in these areas as among the most charitable, they are in fact substantially reliant on fees for the services they provide. About 27 percent of their revenues are fees paid by private sources and another 26 percent comes from government payments for services provided to individuals qualified for government assistance. Such organizations also receive government grants accounting for 21 percent of revenue, making them the subsector most reliant on government funds (McKeever et al., 2016, pp. 208–212). This reality reflects, in part, the devolution and outsourcing of social programs over recent decades, as mentioned earlier in this text. Dependence on government funds also makes many human service organizations vulnerable when public policy shifts and government social spending declines. They are also vulnerable, of course, to declines in giving during economic recession, just when the need for their services may be increasing. For this reason, among others, many of the efforts to diversify revenues by developing alternative sources, including business enterprises, have occurred in this subsector. It is also the focus of much of the discussion regarding the need for improved management and accountability in the nonprofit sector as a whole. While there are certainly many volunteers working in human service organizations, there also has been a trend toward more professionalized management of such organizations in recent decades. In many instances, volunteers are managed by staff who have specialized training and skills in the management of volunteer programs.

*International and Foreign Affairs.* The subsector of international and foreign affairs included just 2 percent of public charities in 2013 (McKeever et al., 2016, p. 212). This subsector encompasses organizations engaged with international exchange programs, international development and relief efforts, international peace and security, and human rights. Although such organizations do receive government grants, they are substantially reliant on gifts and grants from private donors, which account for 65 percent of the subsector's revenue (McKeever et al., 2016, p. 214).

*Other Public Charities.* A wide variety of organizations are sometimes just described as “other public charities” (McKeever et al., 2016, p. 216). They include those pursuing public and societal benefit in fields such as civil rights, community improvement, the promotion of philanthropy, and research, among other purposes. Some religious organizations that are not congregations are also included in this subsector. Together, these organizations account for 18 percent of public charities, and they reflect varied patterns in terms of their sources of revenues.

*Funding Intermediaries.* Funding intermediaries are organizations that exist for the sole purpose of directing money to other nonprofits (Salamon, 2012a). They are tax-exempt under Section 501(c)(3), and thus gifts made to them are tax deductible to the donor. But they are also different from the organizations described in the previous sections of this text. With some exceptions, they do not themselves operate programs; rather, their role is, in a sense, to be like the bankers of the nonprofit sector, channeling private giving to other, service-providing nonprofits. Some are public charities, including, for example, United Way, the Jewish Federations of North America, and community foundations. They raise money from the public and then redistribute it to other organizations that serve their communities. Other funding intermediaries are private foundations, funding intermediaries that work under a somewhat different set of rules. Let's look more closely at those distinctions.

## Public Charities and Private Foundations

As shown in Figure 2.1, there are two different types of charitable nonprofit organizations that are exempt under Section 501(c)(3)—public charities and private foundations. There are technical definitions of these terms established in tax law, but it is sufficient to understand

that **public charities**, as the term suggests, are organizations that receive support from a relatively large number of donors or from government, that is, from the public. Both public charities that provide direct services, such as hospitals, and funding intermediaries that are public charities, such as United Way, generally spend a significant portion of the gifts they receive each year.

**Private foundations**, on the other hand, usually have only one or perhaps a few donors—often one person, one company, or the members of a family. For example, the Bill & Melinda Gates Foundation was funded through gifts from Bill and Melinda Gates, and the Ford Foundation was created through gifts from Henry Ford. It is a common misunderstanding to think that the Gates Foundation was created by Microsoft and the Ford Foundation by the Ford Motor Company. In reality, the funds used to establish the Gates Foundation were those belonging to Bill and Melinda Gates personally. Likewise, the Ford Foundation was created by Henry Ford with his personal fortune, not by the Ford Motor Company. There are more than 86,000 private foundations in the United States (Foundation Center, 2019). There are various types, which are discussed in a later chapter of this book.

Private foundations receive different tax treatment than public charities. One significant difference lies in the tax deductions allowed to individual donors for gifts to public charities and private foundations. Beginning in 2018, cash gifts to public charities are deductible up to 60 percent of the donor's income while deductible gifts to private foundations are limited to 30 percent of the donor's annual income (Council on Foundations, 2018). (In 2020, emergency federal legislation in response to the COVID-19 pandemic temporarily increased the percentage of income that could be deducted for cash gifts to charitable nonprofits by individuals who itemize their deductions, to 100 percent of annual income. At the time of this writing, that change was expected to be temporary, but nonprofit organizations were advocating for permanent change in the tax law.) In both cases, there may be additional limitations, depending on the nature of the assets used to make the gifts, and donors may be able to claim deductions for the amount exceeding those limits in later years. In addition, the investment earnings of private foundations are subject to a tax, and they face a requirement for minimum spending of their investment returns that does not apply to public charities. What level of spending should be required of private foundations and what should be included in the definition of that spending have been sources of recurring debate. Unlike public charities, private foundations are not permitted to engage in lobbying. Many nonprofit organizations generally prefer to be classified as public charities in order to avoid the limitations and costs that come with being deemed a private foundation. They will take care to ensure that their revenues are sufficiently diversified and that their activities are consistent with public charity status, which the IRS may sometimes challenge.

Now let's add yet another complication! There are funding intermediaries that use the word *foundation* in their name but are in fact public charities. Some people refer to them as **public foundations** in order to distinguish them from the private foundations that we have been discussing. One type, the community foundation, receives gifts from members of a particular community and makes gifts to support a variety of service-providing nonprofits in that community. Another type of foundation that is a public charity is the **institutionally related foundation**. These foundations are the fundraising arms of their host or parent organizations. They are public charities because they solicit and receive gifts from the public, but unlike the United Way or community foundations, which make grants to multiple organizations, this type of foundation directs its support to just *one* organization. Such foundations are commonly associated with public universities. For example, the University of Maryland Foundation raises, invests, and manages funds for the state university it serves. Some federal government entities also have affiliated foundations that seek private gifts to supplement the funds that the agency receives through public appropriations. An example of this mentioned earlier is the National Park Foundation, a fundraising entity that supports the National Park Service. And, as in the case of the Sierra Club and the Sierra Club Foundation, there are

foundations associated with nonprofit organizations that do not themselves qualify to receive tax-deductible contributions.

To complicate things yet further, there are private foundations that do not make any, or many, grants to other nonprofits and that may not even have the term *foundation* in their names. For example, Colonial Williamsburg, in Virginia, and Longwood Gardens, in Pennsylvania, are legally private foundations, but all of their funds are used to support their own programs and operations. They are thus **operating foundations** rather than grant-making foundations and, with some exceptions, are not sources of financial support for other nonprofits. For these organizations, being a private foundation is a matter of status under the tax law and relates to the source of each foundation's support, but their operations may be similar to those of nonprofits that are public charities. Tax law related to private operating foundations is different in some ways from the law related to nonoperating private foundations. We will consider foundations again in Chapter 13 as part of our discussion on fundraising. Students who are interested in how foundations are managed will find there are many excellent resources, including books and the websites of Candid (<https://candid.org/>), the Council on Foundations (<https://www.cof.org/>), and Grantmakers for Effective Organizations (<https://www.geofunders.org/>), among others.

## Salamon's Anatomy

We now have discussed two basic ways of differentiating the nonprofit sector: the NTEE and the classifications of organizations under the IRS code. Let's look at a couple of other ways that scholars have divided up the sector. Both the IRS classifications and the NTEE identify organizations according to the principal activities in which they are engaged. Some scholars have sought other ways of categorizing nonprofits, developing various maps to bring greater clarity to our understanding of the structure of the nonprofit sector along other lines (e.g., Gamwell, 1984; D. H. Smith, 1991; Sumariwalla, 1983; Van Til, 1988, 2000). Among them is Lester Salamon. In his book *America's Nonprofit Sector*, Salamon (2012a) divides the universe of U.S. nonprofits into two broad categories, member serving and public serving, and then defines various subcategories on each side of that divide—a design he calls the “anatomy” of the nonprofit sector (p. 30).

As the term implies, **member-serving organizations** exist primarily to secure benefits for the people who belong to them or who support them through dues, membership fees, or other contributions. They include, for example, social and fraternal organizations, business and professional associations, and labor unions.<sup>3</sup> In general, their sources of support and the beneficiaries of their programs are one and the same, although society may benefit indirectly—such as through the improvement of skills among members of a profession that serves the public's needs. These organizations are tax-exempt but not eligible to receive tax-deductible gifts. They are not charitable organizations (although some may have affiliated charitable foundations). Salamon's examples of **public-serving organizations** include churches, the charitable and social welfare organizations we have discussed, as well as foundations and other funding intermediaries. Salamon's anatomy provides another useful way to think about the nonprofit sector, classifying nonprofit organizations not by the nature of their activities, like the IRS or the NTEE, but rather by who receives the principal benefit of those activities. However, while it adds clarity in certain respects, it also raises questions. For example, Salamon (2012a) puts religious congregations in the public-serving category. They surely are tax-exempt and eligible to receive tax-deductible contributions—they are 501(c)(3) organizations—but it seems possible that their activities might more directly serve their own members than the general public. As Salamon (2012a) acknowledges, “The distinction between primarily member-serving and primarily public-serving nonprofit organizations is far from perfect. . . . Even the member-serving organizations produce some public benefits,

and the public-serving organizations often deliver benefits to their members” (p. 31). Despite some shortcomings, Salamon’s anatomy has contributed to the vocabulary of the nonprofit field, and it is not unusual to hear people refer to organizations as “member serving” or “public serving.”

## The Spectrum of Organizations

So far, we have looked at ways of differentiating nonprofit organizations according to their purposes and activities (the IRS classifications and the NTEE), according to who benefits from their activities (member-serving and public-serving entities), and according to their sources and patterns of support (public charities and private foundations). Yet another way to differentiate nonprofits is according to the degree to which they are commercialized—that is, the extent to which they operate like businesses.

In their landmark 2001 book, *Enterprising Nonprofits: A Toolkit for Social Entrepreneurs*, J. Gregory Dees, Jed Emerson, and Peter Economy depict a spectrum of nonprofit organizations, which they call “social enterprises.” Their spectrum is depicted in Table 2.1. Each endpoint on the spectrum represents an extreme—that is, a pure example of two alternative conditions. The spectrum encompasses every possible point in between. In this spectrum, the two extremes are organizations that are “purely philanthropic” and those that are “purely commercial,” defined by their “general motives, methods, and goals” and their relationships with their key stakeholders (Dees et al., 2001, p. 15). In other words, we might think of those at the left endpoint of the spectrum as the most nonprofit-like and those at the right endpoint

Table 2.1 The Social Enterprise Spectrum

	Continuum of Options		
	Purely Philanthropic	Hybrid	Purely Commercial
<b>General motives, methods, and goals</b>			
	Appeal to goodwill	Appeal to mixed motives	Appeal to self-interest
	Mission driven	Balance of mission and market	Market driven
	Goal is social value creation	Goal is social and economic value creation	Goal is economic value creation
<b>Key stakeholders</b>			
Beneficiaries	Pay nothing	Pay subsidized rates and/or a mix of full payers and those who pay nothing	Pay full market rates
Providers of capital	Make gifts and grants	Provide below-market capital and/or a mix of below-market capital, market-rate capital, and gifts	Charge market rates
Workforce	Volunteers	Accept below-market wages and/or a mix of volunteers and paid staff	Receive market-rate compensation
Suppliers	Make in-kind gifts	Provide special discounts and/or a mix of full price, discounts, and in-kind gifts	Charge market prices

Source: Adapted from Dees et al. (2001, p. 15). Used with permission of John Wiley & Sons, Inc.

as the most business-like. In between, at various points along the spectrum between the two extremes, are most nonprofit organizations today.

Let's walk through the spectrum of Dees et al. (2001), thinking about three organizations, including two we saw on our hypothetical tour of Washington, DC—Miriam's Kitchen and the George Washington University—and a third that is familiar to all of us, Microsoft Corporation. Even Miriam's, which is close to what most people would think of as a purely philanthropic nonprofit and thus somewhere close to the left end of the spectrum, is not entirely pure according to the criteria of Dees et al. because it does employ paid staff. But it is close enough to serve as an example for our discussion. Microsoft, most would agree, is close to a pure example of a commercial organization, at the right end of the spectrum. The George Washington University is somewhere in between—in the terminology of Dees et al., it is a hybrid that is somewhat nonprofit-like and somewhat like a business. This is true of most private colleges and universities and, in some ways, increasingly true of public universities as well.

What characterizes organizations that are purely philanthropic? As the chart by Dees et al. (2001) indicates, such organizations appeal to goodwill rather than self-interest. People serve as volunteers and make gifts to Miriam's Kitchen because they hold compassion and concern for homeless individuals. But few would buy the Windows operating system because Microsoft needs the money! What about universities? They appeal to mixed motives. People do feel altruistic about universities; that's why many alumni continue to make gifts long after they have graduated. But, for most students, attendance at a university is also a practical investment. Although some may value learning for its own sake, most are likely motivated to study at least in part by self-interest, that is, by interest in their own financial and career futures.

Philanthropic organizations are mission driven. If they are purely philanthropic, then, at least theoretically, they pursue the mission with little regard for the financial bottom line. Although this image may comport with the stereotype that some may hold of nonprofits as organizations run by dedicated volunteers unconcerned with money, an example of that purest form would be somewhat difficult to find in today's nonprofit world, for many of the reasons we already have discussed. On the other hand, Microsoft is unlikely to produce software that nobody wants to buy, regardless of what social value it might serve—it is, like all businesses, market driven. What about a university? Again, most are mixed, balancing commitment to a mission with responsiveness to the market. A university may continue to offer academic programs or to support research efforts that are not profitable, indeed, that even require a subsidy, because they are important to its educational mission. But most universities also respond to the market, developing new programs and expanding others that are attracting increased student interest.

Philanthropic organizations are concerned with creating social value—that is, with improving the lives of individuals and their communities; they are not about making money for its own sake. In contrast, as we have discussed before, the principal goal of a business is to create economic value—in other words, to generate profits and increase its owners' wealth. Again, the hybrids that Dees et al. (2001) define pay almost equal attention to both components of the double bottom line, focusing on the creation of both social and economic value, or in the words of Bill Shore (1999), they may be “doing good by doing well” (p. 110).

Let's look at our three sample organizations' relationships with some of their key stakeholders—their beneficiaries (clients), those who provide them with capital funds, their workforce, and their suppliers. At purely philanthropic organizations, clients pay nothing for the services they receive, like the homeless men and women who are served by Miriam's Kitchen. On the other end of the spectrum, people generally pay for their Microsoft software at whatever market price prevails. And hybrids? Let's consider a typical undergraduate classroom in a private university. Some students will be attending on full scholarships—they pay nothing

in the way of tuition. Others, from more affluent families, may be paying the full tuition price listed in the university bulletin, while still others will be paying some portion of the listed tuition with scholarships to cover the rest. This is typical of hybrid nonprofits, including universities and hospitals, which often serve a mix of full payers and subsidized clients.

If Miriam's needs capital to expand or meet special organizational needs, it will most likely obtain it through fundraising for gifts or grants. Microsoft will issue new stock or borrow money, paying the full market rate of interest. Hybrids often mix these methods, except, of course, that a nonprofit cannot issue stock. For example, a university may have a campaign to raise capital dollars through gifts but may also borrow funds for the construction of new buildings. Nonprofits sometimes can borrow at less than the market rate of interest, although some will also borrow at the going market rate as well.

The purely philanthropic workforce is composed entirely of volunteers. As we have discussed, this is the case for some small nonprofits, although many (including Miriam's Kitchen) have paid staff members in addition to a substantial volunteer workforce—they are not, in the terminology of Dees et al. (2001), “pure.” However, it is likely that almost no one volunteers at Microsoft. The company pays market wages and, indeed, competes in the marketplace for talent. Universities, as any professor will testify, are somewhere in between; professors do not work for free, but neither do they earn the salaries their talents might command in a purely commercial enterprise.

How do nonprofits obtain needed supplies? A purely philanthropic nonprofit would have all its supplies contributed; that is, it would receive them through gifts-in-kind. Miriam's does receive such gifts, although it also purchases food that it needs for its meal programs. However, it is doubtful that Microsoft ever receives such gifts, and it likely pays the market price for pencils as well as computers (although it may negotiate some discounts based on volume rather than the generosity of its suppliers). As a hybrid, a university may receive some gifts-in-kind, pay market price for some products, and receive educational discounts on others.

Again, it is important to emphasize that the concept of a spectrum includes various points along the line rather than two or three discrete categories, so organizations may be hybrids to a lesser or greater extent. Indeed, the reality in today's nonprofit sector is that relatively few organizations offer an example of the purely philanthropic, as the chart by Dees et al. (2001) defines it. Most are hybrids to some degree, even Miriam's Kitchen. Are there examples of purely commercial organizations? Microsoft may come pretty close, but some argue that for-profit businesses are in fact becoming more nonprofit-like. While many nonprofits demonstrate increasing degrees of commercialization—that is, they are moving from left to right across the spectrum of Dees et al., many corporations are becoming more attuned to their social responsibilities, tempering their pursuit of profit at least somewhat with a concern for social value. In terms of the spectrum of Dees et al., they may be moving to the left (no political pun intended!). Because of these movements in both directions across the spectrum, some see a blurring of the nonprofit and for-profit sectors. Some celebrate it, while for others it arouses deep concern. We will return to this point in other contexts later in this text.

## Emerging New Models

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As our preceding discussion of the spectrum established, the blurring of the nonprofit and for-profit sectors has led to more organizations that generate revenue from both charitable gifts and business ventures and that utilize business methods and approaches in pursuit of their social missions. Some who observe the blurring of the sectors and the emergence of hybrid organizations advocate a new legal framework and a new definition of organizations.

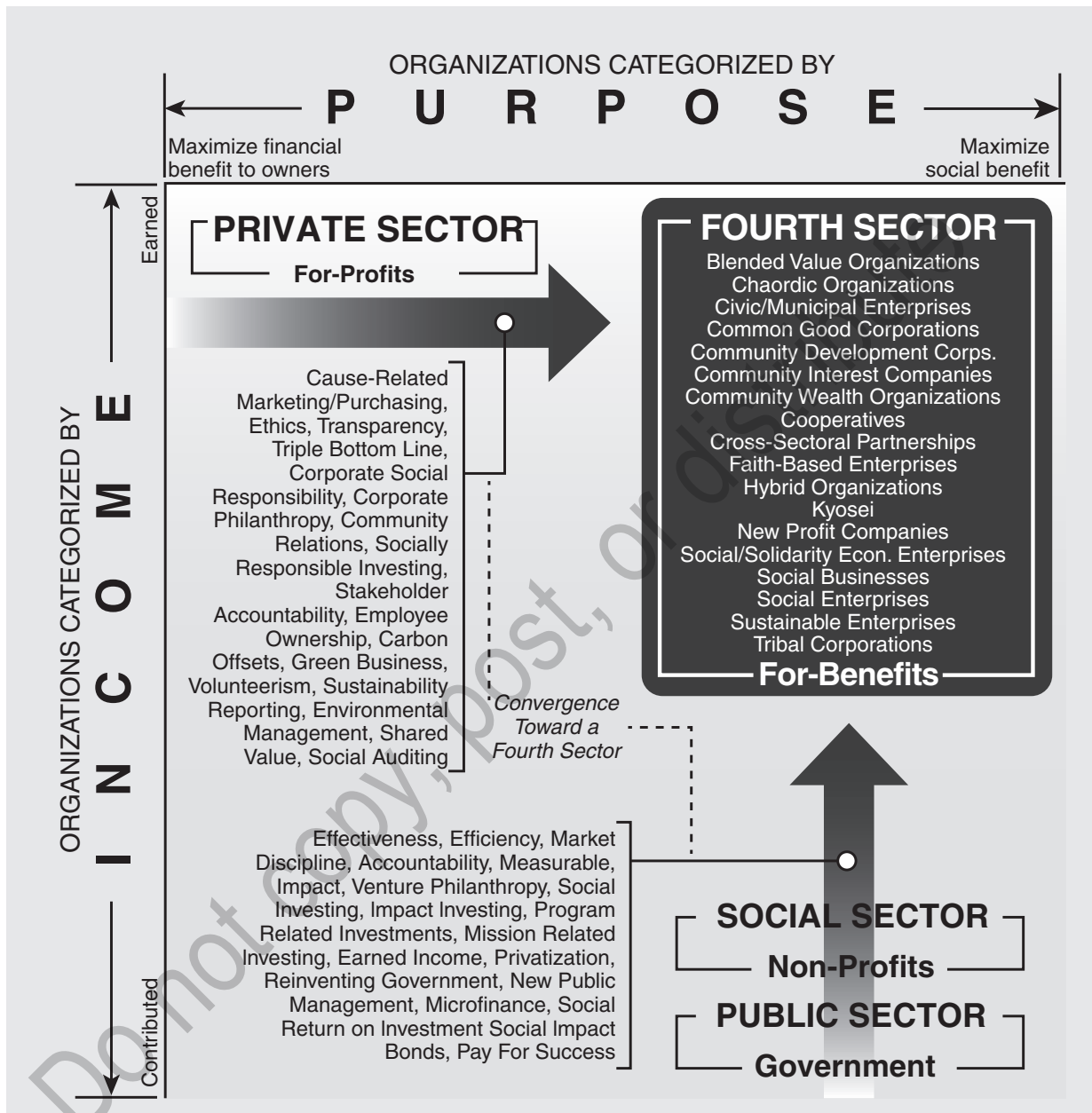
In an influential 2009 report, Heerad Sabeti describes the increasing use of business methods by nonprofits and the growing responsiveness of business to social concerns, and sees “a new class of organizations with the potential for generating immense economic, social, and environmental benefits . . . emerging” (p. 2). Sabeti observes that “organizations within the three sectors [public, for-profit, nonprofit] have been evolving—or converging—toward a fundamentally new organizational landscape that integrates social purposes with business methods” (p. 2). This convergence is creating a new sector, or “fourth sector,” that Sabeti thinks “can be consciously developed and expanded through broad recognition and engagement” (p. 1). Julie Battilana, Matthew Lee, John Walker, and Cheryl Dorsey (2012) also note the increasing social responsibility of some corporations, as well as nonprofits’ growing pursuit of earned income. While for-profit firms create economic value and nonprofits create social value, the authors suggest that a “hybrid ideal” may emerge. As they describe, “This hypothetical organization is fully integrated—everything it does produces both social value and commercial revenue” (Battilana et al., 2012).

Figure 2.2 depicts the relationship of the emerging fourth sector to the public, private (business), and traditional nonprofit sectors. The two relevant variables are the extent to which the organization benefits society or owners and the extent to which its revenues are derived from contributed income (i.e., charitable gifts) or earned income (i.e., commercial activities). This depiction is reminiscent of the spectrum of Dees et al. (2001), with the addition of vectors showing some of the forces at work in the convergence of the sectors. Those forces include corporations’ growing concern with social responsibility, environmental sustainability, transparency, and philanthropy, among others. Government and nonprofits are likewise being moved to change by concerns about transparency, efficiency, and the privatization of many services. These combined forces are thus moving organizations in all three sectors in the direction of the fourth sector, which, as Figure 2.2 depicts, includes various new types of organizations as well as cross-sectoral partnerships and alliances, which we will discuss further in Chapter 8.

While many nonprofit organizations have become commercialized to some extent, and, as mentioned earlier, some have established for-profit subsidiaries, some people argue that emergence of the fourth sector requires new legal forms. Three new forms have received the most attention in the United States—the benefit corporation, the social purpose corporation, and the low-profit, limited liability company (L3C). The **benefit corporation** was, as of 2019, recognized in 34 states, with 6 others reported to be considering it (Benefit Corporation 2019b). Social responsibility is included in the corporation’s charter, granted by the state, and the benefit corporation is thus a new legal form (Benefit Corporation, 2019a). It is important to clarify that a benefit corporation is not the same as a **Certified B Corp**. The two concepts are often confused. A Certified B Corp is a for-profit business that has been *certified* by the nonprofit B Lab as following socially responsible practices and having a positive social impact while engaging in commerce (Benefit Corporation, 2019a). This certification is similar to the Leadership in Energy and Environmental Design (LEED) certification offered by the U.S. Green Building Council to buildings that encompass green principles. As of 2019, there were 2,933 Certified B Corps in the United States and around the world (B Lab, 2019). A business might be incorporated as a benefit corporation, but it would still need to apply and meet the standards in order to gain certification as a B Corp.

A benefit corporation (the new legal form) differs from a regular for-profit corporation in the responsibilities of its board of directors. The benefit corporation charter permits corporate directors to sacrifice profit in order to pursue social purposes, without being concerned that shareholders might accuse them of subverting owners’ interests to social goals. That provides the freedom to trade off profit for social benefit without encountering possible legal issues related to the fiduciary responsibilities of the directors. Further, the benefit corporation is required to produce an annual benefit report that assesses the public benefits that it provides (Cordes et al., 2017, p. 280).

Figure 2.2 The Emerging Fourth Sector



Source: Fourth Sector Network website (<http://www.fourthsector.net/learn>).

The second type of new corporate form is the **social purpose corporation (SPC)**. The SPC has some characteristics similar to those of the benefit corporation. One distinctive feature is the requirement that its mission statement explicitly warn investors that the organization may put social benefits ahead of profits. That provision is intended to strengthen the protection against any shareholder efforts to bring pressure for greater profits at the expense of social benefit (Cordes et al., 2017, p. 281).



A third type of organizational form, the **low-profit, limited liability company (L3C)**, also defines a for-profit entity that has the ability to pursue social goals. The L3C was first created under Vermont law in 2008, and, by 2019, there were 1,678 such companies operating in the United States (InterSector Partners, n.d.). An L3C can accept investments and provide a financial return at a rate below what would be expected from a purely commercial entity, in order to provide social benefits. The original intent of the L3C was to facilitate program-related investments by foundations—that is, to give foundations the ability to invest a portion of their assets in grantee organizations for a modest return, possibly in addition to making outright grants. However, there is no evidence that the creation of the L3C form actually increased such investments by foundations. Indeed, there are critics who question the effectiveness of and the need for the L3C concept at all (Cordes et al., 2017, pp. 278–279).

The use of different legal forms to pursue social goals gained visibility in 2015 when Mark Zuckerberg, founder of Facebook, and his wife Priscilla Chan announced the creation of the Chan-Zuckerberg Initiative, with an initial pledge of \$45 billion (Breen, 2016). Rather than establish a traditional foundation, as had Bill and Melinda Gates, Chan and Zuckerberg created an LLC. It is important to understand, however, that the organization established by Chan and Zuckerberg was a business entity (a limited liability company or LLC), not a low-profit limited liability company (L3C) that was just discussed. (Case 2.1, at the end of this chapter, discusses the Chan-Zuckerberg Initiative.)

The emergence of new legal forms may represent the true beginning of a fourth sector; however, as Battilana et al. (2012) discuss, there are still a number of challenges faced by hybrid organizations, including the need to obtain financing from either philanthropy or investors. Some observers predict that a new class of investors, called **impact investors**, may come to meet that need. This group includes individuals and organizations willing to accept lower rates of financial return in exchange for social benefits. As Lester Salamon (2014) argues, perhaps a better term would be social-and-environmental-impact investors, since the goal of such investors is not to have just any impact but rather to “place equal emphasis on the financial and the social and environmental effects [such] investments are supposed to produce” (p. 15). Indeed, the term *ESG*, standing for “environmental, social, and governance,” represents a set of criteria applied by some socially conscious investors in evaluating investment opportunities (Investopedia, 2019).

Related to impact investing is a new form of financial instrument, **social impact bonds**. In simplest terms, investors buy such bonds and the proceeds are used to undertake social programs, generally operated by a nonprofit. If the programs achieve anticipated results, a government agency repays the investors with interest, but if the programs fail, the investors have taken the risk. This approach has received considerable attention in the United Kingdom and is growing in the United States (S. Pandey et al., 2018).

The new legal forms discussed briefly in this chapter are not a major focus of this text, which emphasizes the management of traditional nonprofit organizations. However, even traditional nonprofits pursue earned income through commercial activities, and some have become substantially commercialized. Earned income and the related concept of social enterprise are discussed in more detail in Chapter 14.

## The Commercialization Debate

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Some observers consider the increasing use of business methods in nonprofits and their efforts to develop streams of earned income to be desired, reducing their dependence on government and on gifts and increasing their effectiveness. In his influential 1999 book, *The*

*Cathedral Within*, Bill Shore writes that nonprofits “forfeited the marketplace long ago, simply walked off the field . . . and chose instead to settle for the crumbs instead of the cake” (p. 205). He argues that nonprofits should begin businesses that generate revenue as a way to gain independence from philanthropic giving and government funds. “Redistributing wealth is not going to be enough,” Shore says. “Creating new [economic] wealth is the only course for nonprofits and community-based organizations struggling to meet social needs” (p. 208). Shore is the founder of the nonprofit Share Our Strength, an anti-hunger organization based in Washington, DC, that has pioneered in the development of strategies for earning income. Share Our Strength is the subject of a case study included in the appendix of this book (Case 2: Share Our Strength/No Kid Hungry).

Others who endorse nonprofits increasing their earned income also warn of possible risks. Marya Besharov, Jean-Baptiste Litrico, and Susanna Kislenko (2019) emphasize that revenue-generating activities should be consistent with an organization’s social mission and its core capabilities. However, they warn, “nonprofits often struggle to find new approaches that enhance—rather than distract from—the social mission . . . [and] commercialization initiatives stretch already limited resources and often require new skills and expertise beyond the capacity of the current team” (p. 35). Burton Weisbrod (2004), an economist who was a pioneer in studying the nonprofit sector, also expressed concern that the increasing commercialization of the nonprofit sector might lead organizations to put profit ahead of their social missions. Weisbrod cites the YMCA, which he says has “morphed into a health-and-fitness goliath” (p. 40). Observing the YMCA’s increasing presence in upscale neighborhoods, where it competes with for-profit health clubs, Weisbrod questions whether it has strayed from its traditional mission of serving low-income families and asks “whether it has become overly commercialized and whether it [even] deserves tax-exempt status” (p. 43). He advocates policies to limit the commercial activity of nonprofits while creating stronger tax incentives to encourage traditional charitable and philanthropic giving. (The YMCA is the focus of Case 3 in the appendix of this book.) Thus, the issue of commercialization is more than philosophical; it has implications for the continued tax-exempt status of some nonprofits.

## Commercialization and Tax Exemption

A companion to the common misunderstanding that nonprofit organizations cannot earn profits is the idea that nonprofits are *always* exempt from taxation. They are exempt from income taxation on revenues related to exempt activities—that is, activities that directly address their social missions. But revenues from activities that are not related to the mission are subject to the **unrelated business income tax (UBIT)**. An activity is unrelated and subject to this tax if it meets three requirements: (1) It is a trade or business, as defined by the IRS; (2) it is regularly carried on; and (3) it is not substantially related to the exempt purpose of the organization. The definition of “substantially related” is provided by the IRS (2016), with characteristic clarity:

To determine if a business activity is “substantially related” requires examining the relationship between the activities that generate income and the accomplishment of the organization’s exempt purpose. Trade or business is related to exempt purposes, in the statutory sense, only when the conduct of the business activities has causal relationship to achieving exempt purposes (other than through the production of income). The causal relationship must be substantial. The activities that generate the income must contribute importantly to accomplishing the organization’s exempt purposes to be substantially related.

Activities carried out by volunteers; a trade or business carried out for what the IRS calls the “convenience” of clients or members; and sales of donated merchandise, for example, in a thrift shop, are specifically excluded from UBIT. So, for example, universities generally are not taxed on revenue from dining halls or other food operations since these services are provided for the convenience of students (although it may surprise students to learn this). Similarly, a university parking garage used exclusively by students and faculty would not generate unrelated business income—it is there for convenience and is therefore related to the educational mission. But a garage open to the general public might not meet that test in the view of the IRS. The Tax Cuts and Jobs Act of 2017 included changes in how organizations calculate unrelated business income. The details are beyond the scope of this chapter but can be found on various websites that explain that legislation.

Most business activities undertaken by nonprofits are related to the mission, and the revenues generated are therefore not taxable. For example, a nonprofit that develops a business to employ individuals with disabilities is serving its mission of providing job training and rehabilitation, even though the services it provides may generate substantial revenue and even compete with the services provided by for-profit companies. But the line is not always clear. For example, one area of dispute has been gift shops operated by museums. If an art museum gift shop sells products that include reproductions of paintings in its exhibits, that could be related to its mission of educating and informing the public about art. But sales of products that are not related to the museum’s collections might be regarded as unrelated and subject to the UBIT (IRS, n.d.).

One concern is that unrelated business activities could become a substantial part of the organization’s activities. If they do—in general, if the amount of the nonprofit’s time and resources devoted to the business activity exceeds that devoted to its mission (usually meaning more than 50 percent of activities)—the nonprofit could be in danger of having its tax exemption revoked entirely. The issue of related and unrelated income is far from settled and is often an area of dispute between nonprofits and the IRS. In subsectors where commercialization has advanced the most—for example, health services—the tax exemption of institutions is a topic of continuing political debate. In other words, as a nonprofit becomes more like a commercial enterprise, moving as it were from left to right across the spectrum of Dees et al. (2001), there could come a point at which it will be deemed to have crossed over the line, ceasing to be a nonprofit at all.

## Implications for Nonprofit Managers

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What are the implications for the practice of nonprofit management of increasing commercialization, the blurring of the sectors, the emergence of new legal forms, and related policy debates? It seems unlikely that new organizational forms will replace traditional nonprofits in the foreseeable future, but these trends are changing the landscape, making it more varied and complex. Today’s nonprofit sector requires that managers be somewhat hybrids themselves. They must combine a commitment to their organization’s nonprofit mission with business skills, to manage the double bottom line. They must hold an appreciation for the nonprofit sector’s unique history and traditions while also understanding how to succeed in a competitive marketplace. They must be able to adapt to the social and political forces affecting their organizations while also preserving the core values and defending the special status of their organizations. In other words, as was explained in Chapter 1 of this book, nonprofit management requires a unique blend of skills, distinguishing it from management in government or the for-profit sector. Current trends suggest that the task will not become less challenging in the years ahead.

## CHAPTER SUMMARY

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America's nonprofit sector is large and diverse. Its roots lie in the ancient traditions of charity, philanthropy, and voluntarism; voluntary efforts were prominent in the nation's early days. But the sector's modern form is a product of 20th-century history and especially the period since the 1970s. Although *nonprofit organization* and *nonprofit sector* are the terms most commonly used, others have proposed a variety of alternative names for the sector.

The nonprofit sector is growing steadily. It includes about 1.5 million tax-exempt organizations in the United States that are registered with the Internal Revenue Service and others that are not registered. These organizations may be placed in categories according to the tax-exempt classifications used by the IRS or according to the more elaborated categories of the National Taxonomy of Exempt Entities (NTEE), both of which determine categories based on organizations' principal activities. Most organizations registered with the IRS fall into two classifications—charitable and social-welfare nonprofits. Charitable nonprofits are both exempt from income tax under Section 501(c)(3) of the IRC and eligible to receive tax-deductible gifts from individuals and other donors, with some limitations. Social welfare organizations (often called advocacy organizations) are tax-exempt under Section 501(c)(4), but gifts to them are not tax deductible because they are not limited in their expenditures on lobbying activities. Religious congregations are charitable nonprofits under Section 501(c)(3), but they are unique in being protected by the U.S. Constitution and are not required to register with the IRS, although many do so voluntarily. Leaving aside religious congregations, charitable nonprofits are divisible into subsectors, including arts, culture, and humanities; education; environment and animals; health; human service; international and foreign affairs; and other organizations, including those that provide public and societal benefit. These subsectors show significant differences in their sources of revenue and the extent to which their management has been professionalized. Also important are funding intermediaries, which generally do not operate programs but rather receive gifts that are directed to other nonprofit organizations. They include public charities, such as United Way, and private foundations. Private foundations are charitable nonprofits, but they are not public charities

and thus are subject to different rules under the tax code. There are public charities that use the term *foundation* in their name, but they are not classified as private foundations because they raise money from multiple sources.

In addition to being categorized according to NTEE and IRS classifications, nonprofits may be defined as member serving or public serving. Another way to classify organizations is on a spectrum defining the extent to which they are purely philanthropic or purely commercial. Many nonprofits today are said to be hybrids. They are not purely philanthropic or purely commercial but fall somewhere between those two extremes. This is because they demonstrate a mixture of philanthropic and commercial motives, methods, and goals, and their relationships with their stakeholders demonstrate a mix of philanthropic and business characteristics. Many nonprofits have become more commercial at the same time that some businesses are expressing more concern about social goals. Some see the emergence of hybrid organizations as the beginning of a fourth sector alongside government, business, and traditional nonprofits.

Some business organizations are incorporated as benefit corporations; their charters permit their directors to sacrifice profits in order to achieve social benefits. Others have been certified as B Corps, a designation given to for-profit businesses that follow socially responsible practices in conducting their activities and report on their social impact. The social purpose corporation is another new legal form, which requires the board and management to agree on social purposes. The low-profit, limited liability company (L3C) is a legal form of organization that was first defined in law in Vermont and now exists in other states. Its initial purpose was to facilitate program-related investments from foundations.

Challenges to hybrid organizations include the need to raise funds from either or both philanthropy and financial investors. Investors willing to accept lower financial returns in exchange for social benefits are known as impact investors. Blurring of the sectors pleases some and concerns others, who fear that nonprofits will drift away from their social missions. In this environment, nonprofit management requires a unique combination of commitment, knowledge, and skills.

## NOTES

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1. The terms *nonprofit* and *tax-exempt* are not strictly synonymous since there are some for-profit entities—for example, certain partnerships—that are also not required to pay income tax, and there are organizations that are required to pay taxes but do not distribute profits to owners (Hopkins, 2005). In addition,

“nonprofit” is a status conferred by the charter that an organization receives from its state, while the conditions for tax exemption are defined under tax law.

2. It is a fine but important distinction to understand that the IRS does not “grant” tax exemption to nonprofit organizations. If they meet appropriate criteria, they are tax-exempt under the law. The IRS merely

“recognizes” that status conferred by the law (Hopkins, 2005).

3. This text does not discuss member-serving organizations in detail. Students will find additional materials at the website of the Center for Association Leadership (<https://www.asaecenter.org/>).

## KEY TERMS AND CONCEPTS

advocacy organizations 29	low-profit, limited liability company (L3C) 42	social enterprise 25
benefit corporation 40	member-serving organizations 36	social impact bonds 42
Certified B Corp 40	National Taxonomy of Exempt Entities (NTEE) 27	social purpose corporation (SPC) 41
charitable nonprofits 20	nondistribution constraint 23	social sector 25
charitable sector 24	nongovernmental organizations 24	social welfare organizations 29
charity 22	operating foundations 36	tax-exempt sector 25
civil society sector 25	philanthropy 22	third sector 24
faith-based organizations 32	private foundations 35	unrelated business income tax (UBIT) 43
fourth sector 25	public charities 35	voluntarism 22
hybrid organizations 25	public foundations 35	voluntary sector 24
impact investors 42	public-serving organizations 36	
independent sector 24		
institutionally related foundation 35		

### CASE 2.1 The Chan-Zuckerberg Initiative

Mark Zuckerberg was the first member of his generation, a millennial, to become the CEO of a Fortune 500 company, Facebook. In 2015, Zuckerberg and his wife, Priscilla Chan, announced that they would eventually dedicate 99 percent of their shares of Facebook stock to changing the world. But they would not pursue that goal by establishing a private foundation, following the example of Bill and Melinda Gates and other technology entrepreneurs. They would launch the Chan-Zuckerberg Initiative (CZI) as a for-profit, limited liability company (LLC). Chan and Zuckerberg would transfer shares of Facebook to the new company. Their innovative approach “rocked the philanthropy world” (Baird, 2015).

The Chan-Zuckerberg Initiative’s mission is “to build a more inclusive, just, and healthy future for everyone” (Chan-Zuckerberg Initiative, 2019), but it is not a charitable nonprofit. For that reason, the founders do not receive an immediate tax deduction when they transfer their personal assets to the

LLC, as they would if it were a foundation. But the LLC offers more flexibility than a nonprofit entity. The new company can change its purpose at any time and is not required to provide as much transparency as a private foundation (White, 2015). It can also engage in activities that would not be permitted, or that would be more difficult to accomplish, under a nonprofit structure. The LLC can make charitable gifts, but it is also able to make private investments in for-profit activities, raise private equity, hire lobbyists, become involved in political campaigns, and participate in political debates (Cordes et al., 2017).

When it was announced, some people welcomed Chan and Zuckerberg’s decision to create an LLC rather than a charitable nonprofit, noting the advantages of the double bottom line approach over traditional philanthropy. In this view, the LLC is better, since it can earn profits and reinvest them into other

activities with social benefits, unlike a foundation grant that is “gone for good.” If the LLC invests in companies that provide social benefits, those companies may fail, but that is better than maintaining traditional charities, “which can keep going, even if they are not very effective at their work, as long as they are good at raising money from donors” (Lenkowsky, 2015).

But others expressed concerns. Unlike a foundation, the CZI faces no requirement that it give away a percentage of its funds each year. Although Chan and Zuckerberg said that they would use the assets for social good, some noted that there is no assurance that they would actually make gifts from the LLC in the future; perhaps they would just run it as a business for their own benefit. Unlike a foundation, the LLC does not have transparency. Some express concern about the implications of such consequential resources not being subject to greater public accountability and question whether outsiders will be able to assess the efficacy of CZI’s programs (Youde, 2016).

Some see the creation of CZI as an example of generational change and argue that the criticisms reflect “a way of thinking about capital as outdated as telegrams and rotary phones” (Baird, 2015). From this perspective, the Chan-Zuckerberg approach represents the end of “two-pocket thinking,” meaning that individuals work to earn profits in one component of their lives and then seek to accomplish social change by engaging in philanthropy as a separate activity. The merging of these goals is said to be consistent with the worldview of millennials (Baird, 2015).

By 2019, CZI had made about \$1.6 billion in grants and \$110 million in venture investments (Chan-Zuckerberg, 2019). Chan and Zuckerberg were personally deeply involved in the operation of CZI, and Zuckerberg expressed ambitious goals, including “preventing, curing or managing” most diseases “in the next 100 years” (Balakrishnan, 2016). Some expressed caution about whether such goals could be achieved (Farr, 2018). Others voiced confidence that CZI’s approach to social change would prove to be transformative, perhaps as much as the development of Facebook itself (Baird, 2015).

### Questions Related to Case 2.1

1. How do you evaluate the arguments for and against the Chan-Zuckerberg Initiative? Does it hold more promise of accomplishing social change than traditional nonprofits, or does its lack of transparency and accountability grant too much control to its founders?
2. How does the Chan-Zuckerberg Initiative relate to the social enterprise spectrum and to the fourth sector, concepts discussed in this chapter?
3. Do you think millennials hold a different worldview about philanthropy from those of other generations? If so, why do you think that is the case?

## CASE 2.2 A Double Bottom Line: Ben & Jerry’s

In 1978, Ben Cohen and Jerry Greenfield made a \$12,000 investment and opened an ice cream company, originally called Ben & Jerry’s Homemade. Their goal was to make a profit and also pursue a social mission. As Greenfield expressed it, “We measured our success not just by how much money we made, but by how much we contributed to the community. It was a two-part bottom line” (Folino, 2010). Some people called this approach “Ben & Jerry’s double dip” (Page & Katz, 2012).

The company grew through the 1980s and 1990s and remained committed to the social mission of its founders. With the creation of the Ben & Jerry’s Foundation in 1985, the company gave 7.5 percent of its pretax profits to community-oriented projects. Its operations emphasized environmental sustainability, and it followed enlightened employment and community-relations policies.

By 1984, the company was in need of capital for expansion and undertook a public stock offering. This

*(Continued)*

(Continued)

meant that it now had public shareholders (Folino, 2010). By 1999, the stock had fallen from \$34 to \$17, and some observers said that Ben & Jerry's management style did not include the discipline that investors demanded (Caligiuri, 2012). Pressure began to build to do something that would satisfy critical shareholders. In 2000, Ben & Jerry's announced that it was being acquired by Unilever, a large multinational corporation.

It was reported that cofounder Ben Cohen and some members of Ben & Jerry's board had opposed the sale to Unilever. However, some argued that Ben & Jerry's board had no choice but to sell the company to the highest bidder, which was Unilever. This argument was based on the legal responsibility of a public company board of directors to maximize returns to shareholders. Some offered the case as evidence that a traditional business corporation model is "inhospitable, if not outright hostile" to the pursuit of social goals (Page & Katz, 2012). This understanding of the Ben & Jerry's case is advanced by some who advocate the need for new corporate forms, such as the benefit corporation, that would permit corporate directors to weigh social goals equally with profits to shareholders. However, other legal scholars argue that corporate law did not require the sale and that Ben & Jerry's could have continued to operate and pursue its social goals as an independent company (Page & Katz, 2012).

The new owner, Unilever, offered assurance that Ben & Jerry's would remain committed to its social mission and that it would operate as an autonomous unit of the parent company, with its own board, including the founders (Gelles, 2015). Unilever made a substantial gift to the Ben & Jerry's Foundation and pledged to continue its social commitment while also making the company profitable (Hayes, 2000). However, the new

relationship was not without early tensions. Unilever required greater efficiencies and forced Ben & Jerry's to close a production plant, laying off workers, which previously had been against its values (Gelles, 2015). On one occasion, Unilever refused to permit employees of Ben & Jerry's from placing the company logo on a bus they were riding to a political protest, another break with previous practice (Gelles, 2015).

Unilever did permit Ben & Jerry's to take independent positions on some issues. For example, in 2014, Vermont proposed a law requiring that labels disclose food content that includes GMOs (genetically modified organisms). Ben & Jerry's supported the law and committed to producing GMO-free products, although the parent company opposed the Vermont legislation (Boyle, 2014).

In 2012, Ben & Jerry's became the first wholly owned subsidiary of a multinational corporation to become a Certified B Corp, a step that was supported by Unilever (Field, 2012). A Certified B Corp is required to produce an annual impact report, which scores the company's positive effects on the environment, workers, customers, community, and governance. Ben & Jerry's 2019 report showed a total impact score of 110, the highest on the scale (B Lab, 2019). In addition, parent Unilever increased its commitment to positive social impact, coming to define its own brand in terms of its contributions to sustainable living (Unilever, n.d.). In 2018, longtime Unilever executive Matthew McCarthy was appointed as the new CEO of Ben & Jerry's and pledged to continue and increase its social activism. As he explained, "I get the privilege of leading a team and a business that has a four-decade track record of not only making the best ice cream in the world, but actually putting its money where its mouth is in terms of driving progressive change" (Aiello, 2018).

### Questions Related to Case 2.2

1. Companies like Ben & Jerry's were designed to pursue social goals that reflected the values of their founders. What incentives might there be for a public company, like Unilever, to adopt such values?
2. In your opinion, is it realistic for a public, for-profit corporation to remain committed to social purposes, or will the demands of shareholders and investors for maximum profit inevitably win out over time?
3. The rating criteria for B Corps are provided on the B Lab website at <https://bcorporation.net/certification>. Do the criteria cover everything that should be considered or are there additional criteria that you would add?

## CASE 2.3 Burning Man

In 1986, Larry Harvey and a few friends gathered at Baker Beach in San Francisco and set an eight-foot tall wooden man on fire. This rebellious symbolic action, burning “The Man,” became an annual tradition. More friends joined, and, in 1990, the event moved to a larger space in Black Rock Desert, Nevada. By 2018, Burning Man attracted 70,000 people and had become a nine-day event (Holson, 2018). Every year, “burners,” as participants are called, form a temporary community in the desert, which has become known as Black Rock City.

Burning Man is dedicated to ten philosophical principles: radical inclusion, gifting, decommodification, radical self-reliance, radical self-expression, communal effort, civic responsibility, leaving no trace, participation, and immediacy (Burning Man, 2019). During the annual event, there are displays of art and spontaneous entertainment, and people wear creative costumes, but it is more than a traditional festival. Individuals pay to attend, but no money is exchanged during the event itself. Burners are expected to bring all of their own shelter, food, water, and power and, consistent with the leave-no-trace ethic, to remove everything and return the space to its natural state at the conclusion (Walske, 2018).

In 1997, the Burning Man event had grown to the point that it needed some type of legal structure in order to conduct business and manage risk. Harvey considered forming a nonprofit, but was reluctant to give up control to an independent board as the law might require (Burning Man, n.d.). Instead, he and five other partners formed a for-profit, limited liability company (LLC), called Black Rock City, LLC. Those six individuals, including Harvey, were the owners. However, by 2011, the partners became concerned that the LLC structure might become problematic in the future. For one thing, it would permit the owners to pass along their interests to heirs, who might not share the values of Burning Man. They also thought

it might not be an appropriate form to support global expansion and undertake philanthropic initiatives, such as supporting the arts (Creedon, 2014).

The partners decided to form a new nonprofit organization, the Burning Man Project (BMP), which would become the sole owner of the existing LLC (Burning Man, 2014). The individual partners received compensation for their past work, but they gave their shares in the LLC to the new nonprofit, remaining involved as members of the nonprofit board (Walske, 2018). In 2016, various donors gave funds to acquire a permanent site for BMP, but the organization’s revenues continued to be primarily from the sale of tickets to the annual event, totaling almost \$38 million that year (Walske, 2018).

What has become known as “Burner culture” has spread beyond Black Rock City, with independent but similar events now held in various countries (Walske, 2018). Over the years, the annual event in Nevada has also evolved. Despite its philosophical emphasis on egalitarianism and anti-commercialization, Burning Man ticket prices in 2019 ranged as high as \$1,400, and the event had come to be popular with celebrities and Silicon Valley billionaires, some of whom were setting up luxury camps and bringing their own chefs and bodyguards (Warren, 2019). One site offered a “culinary and beverage program which focuses on raw and cooked organic food,” “yoga retreats,” “meditation and energy healing sessions,” and “artists and DJs to align your heart pace with the beats of our sets” (Boucher, 2019).

In 2019, Marian Goodell, BMP’s chief executive, announced new rules and reduced ticket prices, intended to achieve a more diverse community and return Burning Man to its original values. Noting the trend toward upscale campsites and commercialization of the event, she wrote, “Seriously, people, this really isn’t Burning Man” (Holson, 2019).

### Questions Related to Case 2.3

1. In addition to retaining more control, what other advantages of the limited liability company (LLC) form may have been attractive

to Larry Harvey and the other founders of Burning Man in 1997?

*(Continued)*



(Continued)

2. What advantages and disadvantages may have accompanied the conversion to a nonprofit in 2011?
3. Larry Harvey thought that creating a nonprofit in 2011 would preserve Burning Man's original culture and values better than continuing as a limited liability company. Yet, by 2019, some people thought that the event had evolved away from those original principles. What do you think might have been the causes of that change? Did it have anything to do with Burning Man's legal status or was it attributable to other things? Would the shift still have occurred if it had been a nonprofit from the start?

## QUESTIONS FOR DISCUSSION

1. If you had \$25 to give today to any nonprofit organization, which one would it be? Now, imagine that you are 80 years old and have \$1,000,000 to give to an organization at the event of your death—that is, through your will. Which one would it be? Do your answers reflect a difference between charity and philanthropy?
2. If you were the president of an independent (nonprofit) college or university, what things would you consider in making a decision on a possible tuition increase, which might enhance your bottom line but possibly work against your mission of providing educational opportunity?
3. Should gifts made by individuals to a nonprofit organization that receives the largest portion of its revenues from fees for services—for example, a hospital that is mostly supported by payments from patients and insurance—be fully tax deductible, partially tax deductible, or not deductible at all? Explain your answer.
4. Suppose a nonprofit organization operates a business that is related to its mission, such that revenue is not subject to the UBIT, but it competes directly with a for-profit business nearby that must pay taxes. For example, think about a nonprofit bookstore that is near another bookstore run by private owners as a for-profit business. Is that unfair competition with the for-profit businesses? Should the nonprofit be taxed just to level the playing field? Why or why not?

## APPENDIX CASES

The following cases in the appendix of this text include points related to the content of this chapter: Case 2 (Share Our Strength/No Kid Hungry); Case 3 (The Y).

## SUGGESTIONS FOR FURTHER READING

### Books

- Buffet, H. W., & Eimicke, W. B. (2018). *Social value investing: A management framework for effective partnerships*. Columbia University Press.
- Hopkins, B. R. (2019). *The law of tax-exempt organizations*. Wiley.
- Ott, J. S., & Dicke, L. A. (Eds.). (2016). *The nature of the nonprofit sector* (3rd ed.). Westview.
- Salamon, L. M. (Ed.). (2015). *New frontiers of philanthropy: A guide to the new tools and new actors that are reshaping global philanthropy and social investing*. Oxford University Press.

Young, D. R., Searing, E. A. M., & Brewer, C. V. (Eds.). (2016). *The social enterprise zoo: A guide for perplexed*

*scholars, entrepreneurs, philanthropists, leaders, investors and policymakers*. Edward Elgar.

### Articles/Book Chapters

Cordes, J., Dietz, N., Steuerle, C. E., & Broadus, E. (2017). New ways of creating social value: Hybrids. In E. T. Boris & C. E. Steuerle (Eds.), *Nonprofits and government: Collaboration and conflict* (pp. 263–290). Rowman & Littlefield/Urban Institute Press.

Miller, C. (2016, July 1). Millennials and hybrid legal structures are here to stay. *Stanford Social Innovation Review*. <https://>

[ssir.org/articles/entry/millennials\\_and\\_hybrid\\_legal\\_structures\\_are\\_here\\_to\\_stay](https://ssir.org/articles/entry/millennials_and_hybrid_legal_structures_are_here_to_stay)

Sandberg, B. (2019). Critical perspectives on the history and development of the nonprofit sector in the United States. In A. M. Eikenberry, R. M. Mirabella, & B. Sandberg (Eds.), *Reframing nonprofit organizations: Democracy, inclusion, and social change* (pp. 26–36). Melvin & Leigh, Publishers.

### Websites

Alliance for Nonprofit Management: <https://allianceonline.site-ym.com/default.aspx>

Aspen Institute Program on Philanthropy and Social Innovation: <https://www.aspeninstitute.org/programs/program-on-philanthropy-and-social-innovation-psi/>

B Corporation: <https://bcorporation.net/>

Fourth Sector: <https://www.fourthsector.net/>

Global Impact Investing Network: <https://thegiin.org/about/>

Independent Sector: <https://independentsector.org/>

Urban Institute Center on Nonprofits and Philanthropy: <https://www.urban.org/policy-centers/center-nonprofits-and-philanthropy>

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