Comparing Nonprofit and Cooperative Structures

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Nonprofit or cooperative? Questions about the differences between these two types of legal entities are often part of early cooperative development discussions.

These questions may come up when groups are looking at start-up financing. Grants and donations might be considered as a source of low or no-risk seed capital, and an entity must have a nonprofit tax-exempt status to be eligible. Future tax liabilities of the new organization also may be a concern.

Other questions might be related to the governance of the new entity. Groups that are interested in democratic, member-based governance will want to know whether these goals fit with the legal requirements for these entity types.

Understanding the differences between a nonprofit and a cooperative can be confusing because some of the terminology is similar. A nonprofit organization that is tax-exempt appears similar to a cooperative that operates on "not-for-profit" basis and doesn't pay taxes on some of its earnings. Both nonprofits and cooperatives can have members and use member-based governance.

However, though terminology may be similar, there are important differences between the two types of organizations that should be understood before making a final decision on incorporation status.

Tax-Exempt Status

An organization's tax-exempt status is based on two independent but related characteristics: its *incorporation status*, which is determined on the state level; and its federal *tax status*, which is determined by the Internal Revenue Service (IRS).

Incorporation Status

Like any other business entity, both nonprofit and cooperative organizations incorporate under state statutes. These state statutes outline the legal requirements for the entity's governance and operation.

State statutes are not uniform, and entity types and requirements can vary significantly from state to state. Typically the incorporated entity is a corporation that has a legal identity independent of any individual participant or owner.

In Wisconsin, nonprofit organizations usually incorporate as a nonstock corporation under Chapter 181 of the state statutes. While this statute does not prohibit business activities, it requires that any profits from business activity must be retained by the organization to carry out its goals; profits or assets cannot be distributed to individuals.

In contrast, the two cooperative statutes in Wisconsin are types of business statutes that provide guidelines for profit and asset distribution. Cooperative profit distribution to the member-owners is based on patronage – how much business a patron conducted with the cooperative.

Furthermore, a cooperative may issue stock to capitalize its activities, and make distributions to stockholders or other investors in specific situations. In the case of dissolution, assets may be distributed to members as described in the articles and bylaws.

In other states, cooperative incorporation options may be limited due to other restrictions in the cooperative statute. For instance, some state cooperative statutes limit cooperative incorporation to organizations that provide agricultural services to support producers.

Tax Status

A tax exempt organization doesn't pay federal income tax, nor, in some cases, other types of state and employment taxes.

Federal tax exempt status is granted by the IRS to a variety of organizational types. Nonprofit organizations that are exclusively organized and operated charitable or educational purposes as described in sections 501(c)(1) – (28) of the tax code are tax-exempt. The federal tax code requirements are specific about how a particular entity must operate to carry out this exempt purpose.

The tax exemption is granted by the IRS through its own application process; it is not automatically granted on the basis of (non-uniform) state incorporation status.

Cooperatives, however, are eligible for a different type of federal tax exemption. "Operating on a cooperative basis" means that the business operates to deliver services at cost rather than to produce a return to investors, and passes any surplus earnings to patrons.

Therefore the IRS exempts from corporate taxation all cooperative profits that are distributed to members or patrons on the basis of use. Whether these patronage dividends are taxable as income at the member level depends on the type of cooperative service being provided.

Again, because state incorporation statutes are not uniform, the IRS does not grant cooperative tax advantage solely on the basis of incorporation status, but requires other documentation.

Member Governance

Cooperatives in Wisconsin are owned and controlled by their members, typically on a one-member, one-vote basis. Members elect a board of directors from the membership. The board oversees management, and develops the long-range business strategies that both ensure the economic health of the cooperative and meet the needs of the membership.

Wisconsin nonprofits incorporated as a nonstock corporation may have members, but it is not required. The articles of incorporation or organizational bylaws can specify membership types and requirements. Articles or bylaws may also describe whether members elect the board of directors, whether the vote is on a one-member, one-vote basis, and whether the board must be elected from the membership.

Considering Cooperative and Nonprofit Incorporation Options

Groups often focus on making a business structure decision very early in the development process. However, an understanding of the goals of the organization, and how it will meet the needs of the potential membership base, will support better decision-making about financing and organizational structure.

Cooperative start-up groups might consider whether their long-term purpose fits the nonprofit, non-ownership structure. While cooperatives are sometimes described as operating on a "not-for-profit" basis, this reflects the goal of providing member services at cost. "At-cost" does not preclude the cooperative operations from having or profits, which provide a buffer against future losses, and a source for the capital reinvestments necessary for any healthy business.

In a cooperative business structure, these profits, as well as any assets, could be distributed to the member-owners at some point in the future. In a nonprofit structure, surplus or asset distribution to members is not allowed.

Given these future considerations, cooperative start-up groups might consider financing alternatives that do not depend on a nonprofit tax-exempt status.

If the nonprofit, tax-exempt status reflects the organizational mission, and future distributions are not a concern, a nonprofit incorporation option might be appropriate. Under Wisconsin law, this does not preclude the organization setting up a membership-based governance structure similar to that described under cooperative statutes.

The incorporation decision may take longer as the group works through these considerations, but the outcome will support, rather than constrain, the organization's future activities.

Getting professional legal and accounting advice during this process is advisable. But a basic understanding of the differences between the two types of structures, and the goals of the entity being organized, will make the process more helpful and efficient.