



Advising Newly-Forming Nonprofits: Incorporation and Tax Exemption

Ciarra Chavarria, Staff Attorney
cchavarria@lawyersalliance.org

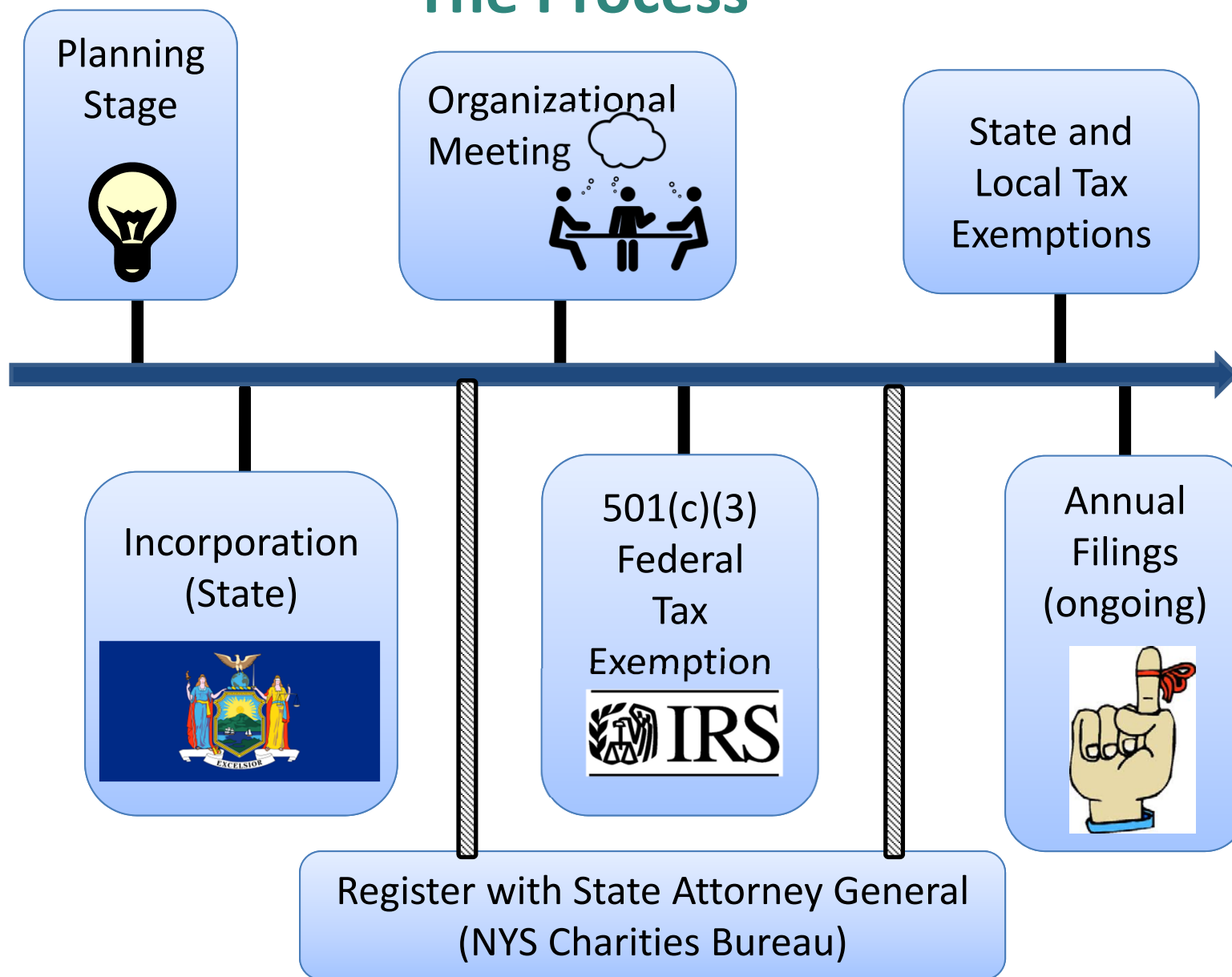
Rafi Stern, Staff Attorney/Legal Fellow
rstern@lawyersalliance.org

Resource Call Hotline: (212) 219-1800 ext. 224

March 26, 2020



The Process





Part I - Incorporation



Incorporation - Advantages

- Groups intending to engage in charitable or educational activity tend to do so either as a nonprofit corporation or unincorporated association
- Incorporation offers several advantages:
 1. Limited liability for directors, officers, and members
 2. Facilitates process of applying for tax exemption
 3. May help generate revenues
 4. Perpetual existence



Incorporation - Disadvantages

- Restrictions on use of assets
- Time-consuming and expensive
- Governed by a board of directors instead of by a founder
- Does not automatically generate revenues
- Difficult to dissolve



Fiscal Sponsorship

- A contractual relationship between a 501(c)(3) exempt sponsoring organization and an organization that intends to carry out a charitable purpose
- Why find a fiscal sponsor?
 - Allows an organization that does not have tax-exempt status to receive grants, charitable contributions and other tax-deductible donations
 - Short-term projects may not need independent status
- Other Considerations
 - Fees, depending on services offered (back office, payroll, etc.)
 - **Two organizations' missions must match** – risk to sponsoring organization
 - Financial stability of sponsoring organization



Forming a Nonprofit

- Nonprofit corporations are governed by the New York Not-for-Profit Corporation Law (NPCL)
- NPCL is based on the New York Business Corporation Law but with significant differences:
 1. Must be formed for non-pecuniary, non-commercial purposes
 2. No shareholders
 - Assets are deemed to be owned by the public
 - Founders have less control
 1. Processes of formation, certain amendments and dissolution are much more involved and time consuming



Types of New York Nonprofits

- “Charitable” nonprofits
 - must be formed for “charitable” purposes: educational, religious, scientific, literary, cultural purposes, or for the prevention of cruelty to children and animals
 - charitable corporations generally qualify as tax-exempt

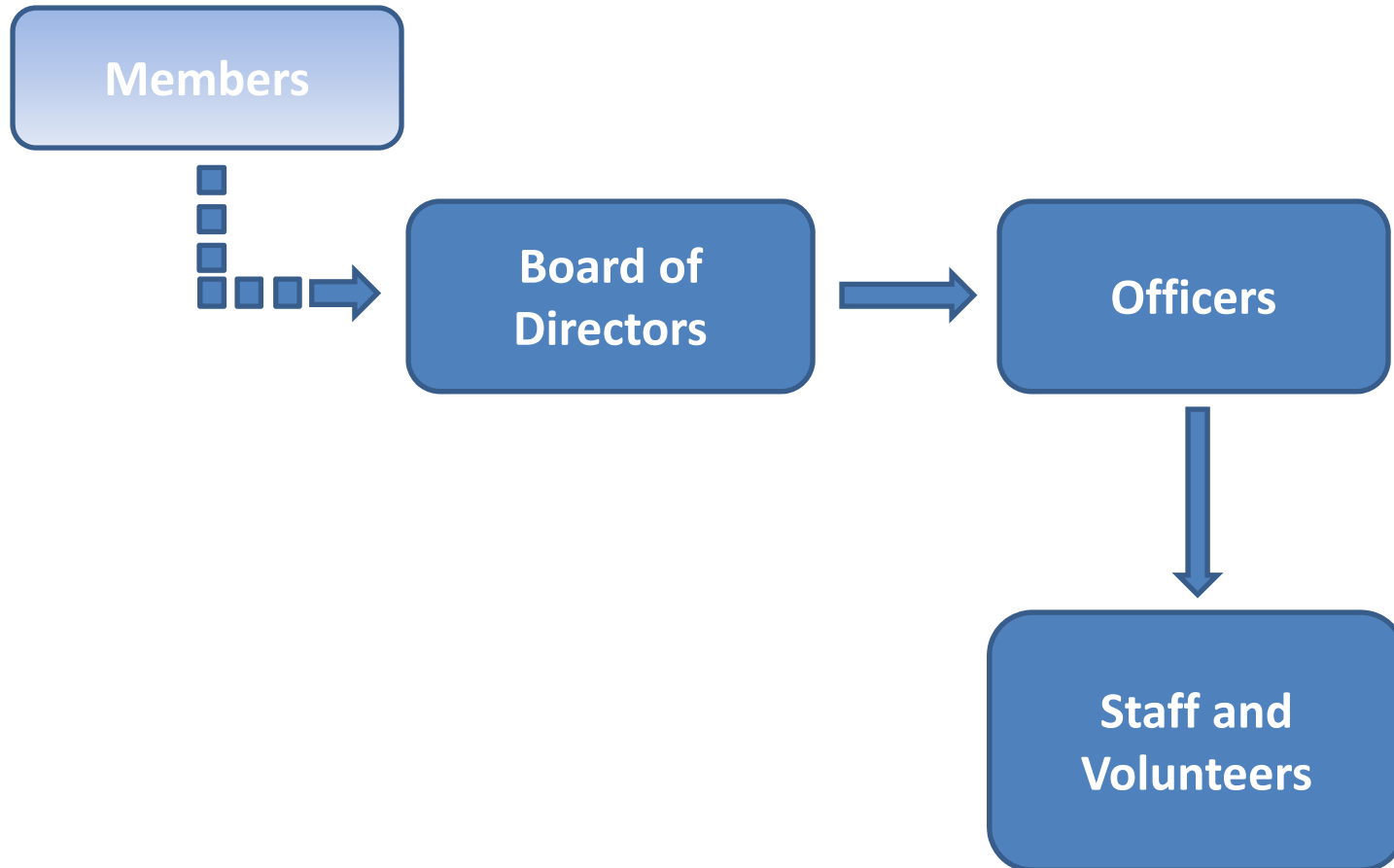


Types of New York Nonprofits

- “Non-charitable” nonprofits
 - formed for other non-pecuniary purposes: e.g., civic, patriotic, political, social, fraternal, athletic, agricultural, horticultural, or animal husbandry, or for the purpose of operating a professional, commercial, industrial, trade or service association
 - must have members
 - usually tax-exempt under other provisions of the Internal Revenue Code (not 501(c)(3))
 - corporations formed for both non-charitable and charitable are deemed to be charitable



Structure of Nonprofits





Structure of Nonprofits

- **Members**
 - Legal members vs. “nominal” members
 - Legal members serve similar function as shareholders in a for-profit
 - Membership structure adds a layer of bureaucracy; small organizations may not be adept at keeping membership list current
- **Board of Directors**
 - Responsible for oversight of organization
- **Officers**
 - Oversee the day-to-day operations of the corporation
- **Staff and Volunteers**
 - Implement programming



Process of Incorporation

- Nonprofit incorporation is handled by the New York Department of State
- Check name, reserve name (optional with \$10 fee)
- Prepare Certificate of Incorporation
 - Purposes clause only required to state whether nonprofit is formed for charitable or non-charitable purposes, but can include more detailed purposes and/or activities
 - Must have three board members and their addresses
- Obtain necessary governmental approvals
- File Certificate of Incorporation with the Department of State
 - Currently costs \$75 + \$10 for certified copy (\$25 for expedited)
- Hold organizational meeting
 - Elect officers and directors, conduct other initial business, adopt bylaws



Bylaws

- Set of agreed-upon rules and procedures for the internal operations of a nonprofit corporation
- Prescribes the decision-making processes of the Board of Directors (the Board) and, for membership organizations, the members
- NPCL establishes the legal framework for bylaws
 - establishes minimum standards to which the bylaws must conform



Bylaws

- Need to have flexibility
- Should provide clear direction and accurately reflect the practices of the organization
- Clear rules and procedures in the bylaws make it easier for organizations and their Boards to function smoothly and efficiently, and focus on the organization's charitable mission:
 - make binding decisions,
 - turn decisions into action, and
 - resolve internal disputes when they arise



What is included in the Bylaws?

- Structure of organization (membership or non-membership)
- Number of directors (must have minimum of three)
- Length of director's term of office/elections
- Quorum/action requirements
- Establishment of executive and other committees
- Maintenance of minutes of board meetings and committee meetings
- Removal of directors
- Procedures/notice requirements for meetings of board and members
- Officers and directors indemnification



Conflict of Interest Policy

- Sets forth procedures for the board to:
 - determine if a conflict exists within a proposed transaction, and
 - address transactions when a conflict arises
- Required for *all* New York nonprofit corporations
- Governed by the NPCL



What is included in the Conflict of Interest Policy?

- Definition of conflict of interest
- Procedure for disclosing a conflict or a possible conflict to the audit committee, board, or other designated compliance officer
- A requirement that a person with a conflict not be present at or participate in board/committee deliberations or vote on the matter giving rise to the conflict; and a prohibition against any attempt by the person with a conflict to improperly influence the deliberation or voting on the matter
- A requirement that the Board must approve the transaction on the basis that it is in the **best interest** of the corporation and must be noted in the minutes of the meeting
- A requirement that the existence and resolution to the conflict be **documented**, including in the minutes of any meeting at which the conflict was discussed or voted on
- Procedures for identifying, disclosing, addressing, and documenting related party transactions.



Conflicts of Interest: Disclosure Obligations

- A requirement that **before** a director is initially elected, and **annually** thereafter, the director must complete, sign and submit to the board secretary a written statement identifying:
 - an entity of which the director is an officer, director, trustee, member, owner, or employee, and
 - any transaction in which the corporation is a participant and in which the director might have a conflicting interest.
 - Initial and annual disclosure statements must be submitted to the audit committee chair, board chair or designated compliance officer.



Whistleblower Policy

- Required for nonprofits with **20 or more employees** and annual revenue in the prior fiscal year in **excess of \$1 million**
- Policy must **prohibit retaliation** against any director, trustee, officer, employee or volunteer reporting in good faith any action or suspected action, taken by or within the organization that is **illegal, fraudulent or in violation of any adopted policy**.
- The policy must include:
 - provisions for reporting suspected violations of laws or policies, including procedures for preserving the confidentiality for those making reports;
 - requirement to designate a person (director, officer or employee) to administer the policy and to report issues to the Board or the Audit Committee;
 - requirement that the policy be distributed to all directors, officers, and employees and to all volunteers who provide substantial services;
 - requirement that person who is subject of complaint cannot be present during board deliberations relating to complaint (except as requested by board in advance of voting.)



Part II – Tax Exemption



Tax Exemption

- For most organizations, incorporation is only the first step
- Organizations apply for tax exempt status because:
 - if not exempt, must pay taxes
 - makes fundraising easier, especially for 501(c)(3) organizations
- Most organizations seek 501(c)(3) status, but there are 27 different types – depends on the purposes and activities of the organization



501(c)(3) Organizations

- Most common because contributions are tax deductible
- Must be organized and operated exclusively for charitable, religious, educational, scientific, literary, testing for public safety, fostering national or international amateur sports competition, or preventing cruelty to children or animals.
- Drawbacks: limits on how purposes are achieved
 - no partisan political activity
 - only limited amounts of lobbying (i.e., influencing legislation)



501(c)(3)s and Lobbying

- Doesn't matter what you call it – supporting or opposing legislation (federal, state or local, existing or proposed) is likely to be lobbying
- If an organization engages in lobbying, two options for determining how much lobbying can be done:
 - *Substantial part test*: facts and circumstances review by IRS. Loss of tax exempt status possible if organization has engaged in substantial part lobbying.
 - *501(h) election*: allows for bright line amount an organization can spend on lobbying without jeopardizing tax exempt status. Penalty is excise tax.



Lobbying and 501(h) Election

Exempt Purpose Expenditures	Total Lobbying Allowance under 501(h)
≤ \$500,000	<u>20%</u> (i.e. \$100,000 max)
>\$500,000 but ≤ \$1 million	\$100,000 plus <u>15%</u> of excess over \$500,000
> \$1 million but ≤ \$1.5 million	\$175,000 plus <u>10%</u> of excess over \$1 million
>\$1.5 million but ≤ \$17 million	\$225,000 plus <u>5%</u> of excess over \$1.5 million
>\$17 million	\$1 million



501(c)(4) Organizations as an Alternative

- Operated exclusively for promotion of social welfare: promoting common good & welfare of the community.
- Social welfare organizations: purpose may be the same as a 501(c)(3) organization, but permissible methods of achieving those purposes are different
- Can engage in a substantial amount of lobbying and up to 50% partisan political activity
- May endorse a political candidate, but cannot contribute funds directly to candidates
- Challenge is that contributions are not tax deductible, so difficult to fundraise



Form 1023 Application

Three basic points must be demonstrated in 1023:

1. Organization is formed for exclusively charitable, education or religious purposes.
2. No part of earnings will inure to private benefit.
3. Will not engage in political activities.



Form 1023 Logistics

- Applications filed *within* 27 months of incorporation receive tax-exempt status *retroactive* to the date of incorporation.
- Applications filed *after* 27 months of incorporation retroactive to the date of filing Form 1023.
- Obtain Employer Identification Number from IRS (like SS #)
- use Form SS-4. Need EIN before filing Form 1023.
- User fee for filing Form 1023 is \$600
- Work on Form 1023 can begin immediately, but need certificate of incorporation and bylaws prior to submission
- Expect process to take several months (longer and shorter wait times not unusual)



Main Elements of Form 1023

- Detailed form, but most questions (and most work for applicants) focuses on narrative description of activities and financial information:
 - Narrative description should document past, present and planned activities. Provide as much detail as possible.
 - Financial information should reflect program activities

Form **1023**
(Rev. December 2017)
Department of the Treasury
Internal Revenue Service

**Application for Recognition of Exemption
Under Section 501(c)(3) of the Internal Revenue Code**

- ▶ Do not enter social security numbers on this form as it may be made public.
- ▶ Go to www.irs.gov/Form1023 for instructions and the latest information.

Refer to IRS Instructions!

Use the instructions to complete this application and for a definition of all **bold** items. For additional help, call IRS Exempt Organizations Customer Account Services toll-free at 1-877-829-5500. Visit our website at www.irs.gov for forms and publications. If the required information and documents are not submitted with payment of the appropriate user fee, the application may be returned to you.

Attach additional sheets to this application if you need more space to answer fully. Put your name and EIN on each sheet and identify each answer by Part and line number. Complete Parts I – XI of Form 1023 and submit only those Schedules (A through H) that apply to you.

Part I Identification of Applicant

1 Full name of organization (exactly as it appears in your organizing document)	2 c/o Name (if applicable)
3 Mailing address (Number and street) (see instructions)	Room/Suite
	4 Employer Identification Number (EIN)



Form 1023-EZ (a streamlined alternative)

- Streamlines the tax exemption application process for small nonprofits seeking 501(c)(3) status
- Generally, only nonprofits that have had less than \$50,000 in revenue for each of the past 3 years, project less than \$50,000 of revenue for each of the next 3 years, and do not have assets whose value exceeds \$250,000 may use the 1023-EZ form.
- Other exceptions apply, so consult the worksheet in the Form 1023-EZ instructions for more information.
- Cost: \$275
- Timing: expect between two weeks to 2 months



Public Charity vs. Private Foundation

- Classification depends on source of organization's financial support.
 - Organization must demonstrate that a significant portion of revenues (normally at least 1/3 of the total, but sometimes as little as 10%) comes from gifts or contributions from the public
 - Public support includes government contracts
- Important because private foundations:
 - are prohibited from any lobbying
 - are subject to 1-2% tax on investment income
 - cannot compensate any directors or officers
 - must make a certain percentage of distributions each year



State and Local Exemptions and Registration

- Once federal tax exemption is obtained, state tax exemption applications are straightforward:
 - State Franchise Tax
 - State and Local Sales Taxes
 - NYC Business Corporation Tax
- **Register** with NY State Attorney General Charities Bureau (online at www.charitiesnys.com)



Annual Filings (Federal): Form 990

- Annual informational tax form required by the IRS from tax exempt organizations
- Form must be filed by the 15th day of the 5th month following the end of the organization's fiscal year
- Public relies on information contained in Form 990
- Option to use Form 990 to report organizational changes (name change, purpose change)
- Different Form 990s filed based upon "gross receipts"
- If no Form 990 is filed for three consecutive years, the IRS will revoke tax exempt status





Form 990 Filing Options

Gross Receipts < \$50k	Form 990-N (or, may choose to file Form 990-EZ or Form 990)
Gross Receipts < \$200k and total assets < \$500k	Form 990-EZ (or, may choose to file Form 990)
Gross Receipts ≥ \$200k, or total assets ≥ \$500k	Form 990

- The full Form 990 should be filed if an organization plans to file for tax exemption, but is not yet exempt
- If Form 1023-EZ is pending, call IRS to be entered into database so organization can file the Form 990-N online



Annual Filing (NY State): Char 500 Form

- File **annual** reports (CHAR 500) with the New York State Attorney General's Charities Bureau
 - must be postmarked within 4 1/2 months after the organization's accounting period ends.

Note: documents filed (including bylaws and certificate of incorporation) are posted to the Charities Bureau website



Annual Reporting to the Charities Bureau: Audit Oversight

- Organizations with an Annual Gross Revenue of \$250,000 or more must file a review report by an independent CPA.
- A full independent audit report is required as follows:

Annual Gross Revenue	
\$750,000+	July 1, 2017 – June 30, 2021
\$1,000,000+	July 1, 2021 and after

*Use *filing deadline* to determine which threshold applies



Audit Committee

- Corporations required to file an audit report must have the board or a designated audit committee oversee the corporation's accounting and financial reporting processes and audit.
 - If opt for audit committee, must be comprised ONLY of independent directors.
- Must annually retain or renew an independent auditor.
- Must review the results of the audit and any related management letter with the auditor.
- Additional duties for organizations with annual revenue over \$1 million (e.g. annually consider independence of the auditor; audit committee report on its activities to the full board)



Unrelated Business Income Tax (“UBIT”)

- Exempt organizations must consider whether it will generate revenue
- An exempt organization can be subject to tax on income if it:
 1. Carries on a trade or business;
 2. Regularly practiced;
 3. That is not substantially related to its exempt purpose.
 - Even if substantially related to exempt purpose, may still be taxed if “overly commercial” in nature



Advising Newly-Forming Nonprofits: Incorporation and Tax Exemption

Resource Call Hotline: (212) 219-1800 ext. 224