



# Becoming a Nonprofit: Incorporation and Tax Exemption

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## About Lawyers Alliance

- Leading provider of business and transactional legal services for nonprofit organizations and social enterprises that are improving the quality of life for low-income New Yorkers



## Disclaimer

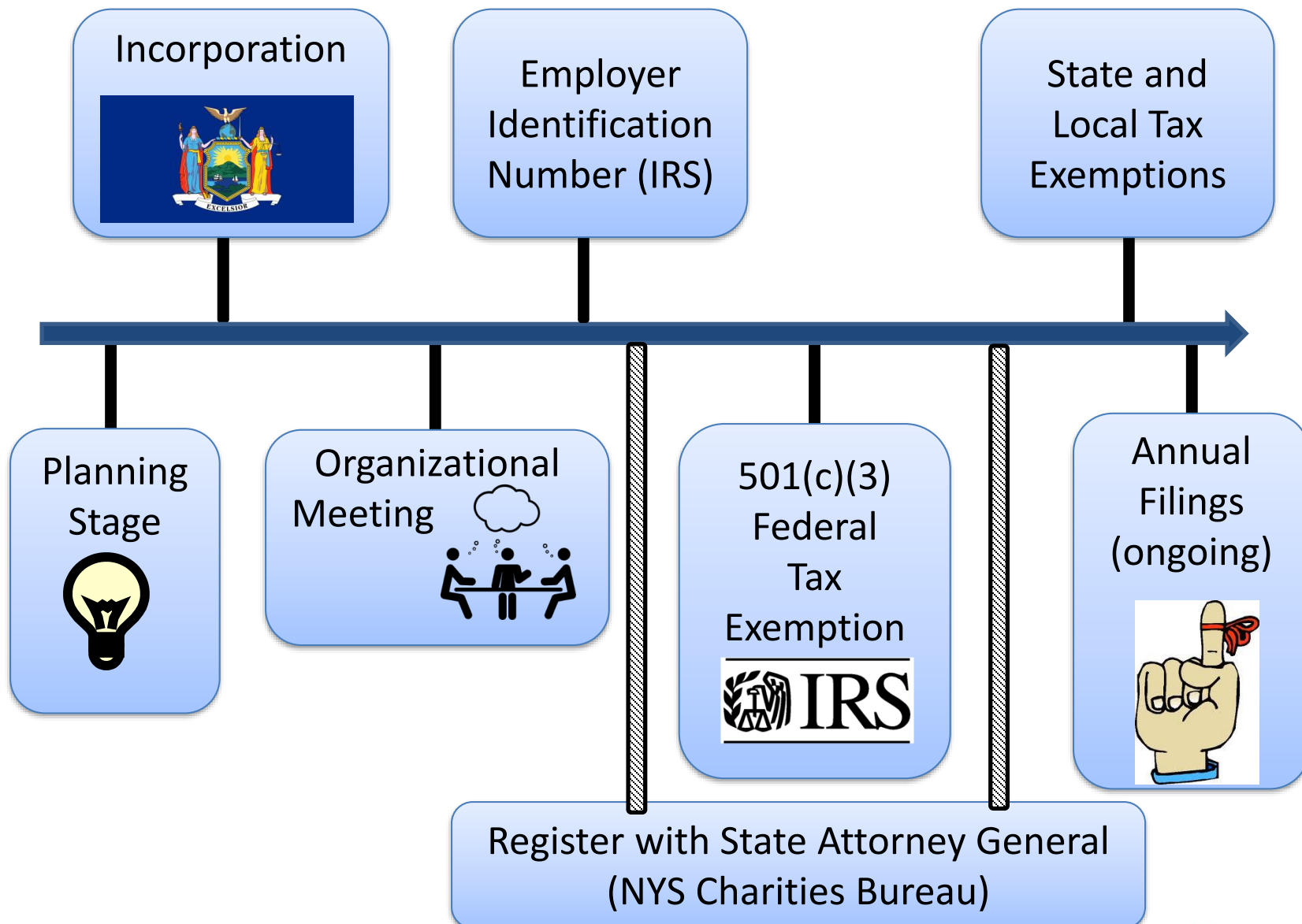
Today's presentation is informational only and is not intended to constitute legal advice. Consult with counsel for legal advice pertinent to your organization.



# Agenda

- Introduction
- Part I: Incorporation
- Part II: Tax Exemption
- Part III: Annual Filings and Ongoing Compliance
- Q&A

# The Process





## Part I – Incorporation



# Incorporation: The Basics

Groups intending to engage in charitable or educational activity tend to do so either as a nonprofit corporation or an unincorporated association

- Advantages of incorporation:
  - Limited liability for directors, officers, and members
  - Facilitates process of applying for tax exemption
  - May help generate revenues
  - Perpetual existence
- Disadvantages of incorporation:
  - 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



# Alternative to Incorporation: Fiscal Sponsorship

- Contractual relationship between a 501(c)(3) sponsoring organization and a group carrying out a charitable activity
- Why find a fiscal sponsor?
  - Group that does not have tax-exempt status can receive grants, charitable contributions and other tax-deductible donations
  - Short-term projects may not need independent status
  - Can test out new idea before expending significant time and resources
- Other considerations
  - Fees, depending on services offered (back office, payroll, etc.)
  - Two organizations' missions must match
  - Financial stability of sponsoring organization





# Forming a Nonprofit: New York vs. Delaware

- New York's nonprofit regime is generally stricter and more burdensome than Delaware corporate law
  - Delaware has simpler and quicker incorporation process
  - Less oversight/approval for major corporate actions/changes
- Delaware nonprofits operating in New York:
  - Will need to obtain certificate(s) of authority in order to conduct programs or provide services in New York
  - Are required to engage and maintain "Registered Agent" to receive all legal documents, which can cost up to a few hundred dollars per year



# 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:
  - Must be formed for non-pecuniary, non-commercial purposes
  - No shareholders
    - Assets are deemed to be owned by the public
    - Founders have less control
  - Processes of formation, certain amendments and dissolution are much more involved and time consuming



# Types of New York Nonprofits: Charitable

- “Charitable” nonprofits:
  - Must be formed for “charitable” purposes as defined in the NPCL: charitable, educational, religious, scientific, literary, cultural, or for the prevention of cruelty to children and animals (NPCL § 102(a)(3-a))
  - Generally qualify as tax-exempt under 501(c)(3) of the Internal Revenue Code (IRC)



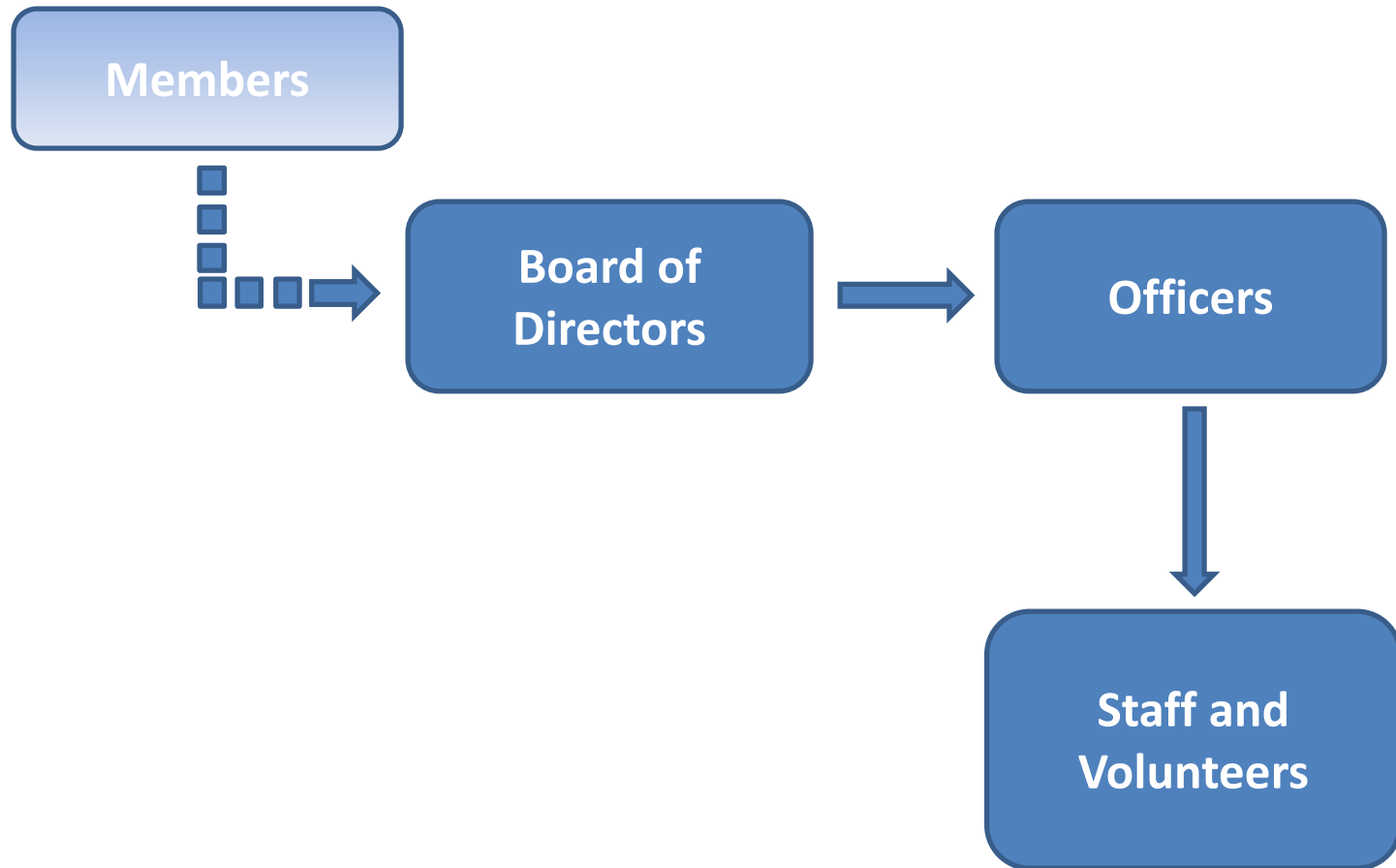
# Types of New York Nonprofits: Non-Charitable

- “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 (NPCL § 102(a)(3-b))
  - Must have members (NPCL § 601(a))
  - Usually tax-exempt under other provisions of the IRC (not 501(c)(3))

**Note:** Corporations formed for both non-charitable and charitable purpose are deemed to be *charitable*. (NPCL §201(b))



# Structure of Nonprofits





# Structure of Nonprofits

- **Members**
  - Legal members vs. “nominal” members
  - Legal members serve similar function as shareholders in a for-profit (but without rights to “profit”)
  - Membership structure adds a layer of bureaucracy (must keep membership list current, send notices, etc.)
- **Board of Directors**
  - Responsible for oversight of the organization
- **Officers**
  - Oversee the day-to-day operations of the organization
- **Staff and Volunteers**
  - Implement programming



# Process of Incorporation

- Handled by the New York Department of State
- Check name, reserve name (optional with \$10 fee)
- Prepare Certificate of Incorporation (NPCL § 402)
  - 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 (if any) (NPCL § 404)
- File Certificate of Incorporation with the Department of State
  - Currently costs \$75 (\$25 for expedited)



# Organizational Meeting (NPCL § 405)

- Initial directors meet to:
  - Adopt bylaws and other key policies
  - Elect officers and directors
  - Conduct other initial business
- May act by unanimous written consent







# Bylaws

- Set of agreed-upon rules and procedures for the internal operations of a nonprofit corporation
  - Legal framework and minimum standards set by NPCL
- Prescribes the decision-making processes of the Board and, for membership organizations, the members
- Clear rules and procedures in the bylaws make it easier for an organization and its Board 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
- Should provide clear direction and accurately reflect the practices of the organization, but provide **flexibility**



# Bylaws: Key Provisions

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



# Conflict of Interest Policy

- Required by NPCL for *all* New York nonprofit corporations (NPCL § 715-a)
- Ensures that transactions with insiders are reviewed by uninterested directors and are fair, reasonable, and in the best interest of the organization
- Sets forth procedures for the Board to:
  - determine if a conflict of interest exists within a proposed transaction, and
  - address transactions when a conflict arises



# Conflict of Interest Policy: Required Provisions

- **Definition** of conflict of interest
- Procedures for **disclosing** a conflict or a possible conflict
- A requirement that the conflicted person **not be present** at or participate in Board/committee deliberations or vote on the matter
- A prohibition against any attempt by the conflicted person to **improperly influence** the deliberation or voting on the matter
- 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**”
- A requirement that directors submit initial and **annual disclosure questionnaires**



# Conflicts of Interest: Disclosure Obligations

- Before a director is initially elected, and annually thereafter, each director must complete, sign and submit a written statement identifying:
  - Any entity of which the director is an officer, director, trustee, member, owner, or employee and with which the corporation has a relationship, and
  - Any transaction in which the corporation is a participant and in which the director might have a conflicting interest.
- Copies of all statements should be submitted to chair of audit committee or Board chair.
- Directors should disclose new conflicts (or potential conflicts) as they arise, even outside of the annual disclosure questionnaire process.



# Whistleblower Policy

- Required for nonprofits with **20 or more employees and** annual revenue of **over \$1 million** (NPCL § 715-b)
- Under NPCL, 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**.
- Under new NY Labor Law, whistleblower protections expanded to former employees and independent contractors and covers **suspected violations of law, regulations, etc.** or activities/policies that **pose a substantial and specific danger to public health or safety**. (NYLL § 740)



# Whistleblower Policy: Required Provisions

- Procedures for **reporting violations** or suspected violations of laws or policies (including procedures for preserving **confidentiality**)
- Requirement that an employee, officer or director be **designated to administer the policy** and report to the Board (or authorized committee)
- Requirement that the person who is the subject of a complaint **not be present** at or participate in Board or committee deliberations or vote (except as requested by Board, to provide information in advance)
- Requirement that the policy be **distributed** to all directors, officers, key persons, employees and volunteers providing substantial services
  - Could include posting on website or conspicuous place in office
  - NYLL § 740 also requires posting of notice (NYS Department of Labor model available)



## POLLING QUESTION:

*Is a Conflict of Interest Policy required for NY Nonprofits?*

- A)** Yes, but only for nonprofits with revenues >\$1m and 20+ employees.
- B)** Yes, always.
- C)** No, but directors must disclose their financial ties.
- D)** No, but it is recommended





# Employer Identification Number (EIN)

- Like social security number for organizations
- EIN required (even without employees) for:
  - Opening a bank account for organization
  - Filing Form 1023 (Application for Tax-Exempt Status)
- “Responsible Party” files Form SS-4 with IRS
  - Can apply online at <https://www.irs.gov/businesses>
- Applying for EIN starts three-year clock for IRS Form 990 filing requirement!

<b>Form SS-4</b> (Rev. December 2019) Department of the Treasury Internal Revenue Service		<b>Application for Employer Identification Number</b> (For use by employers, corporations, partnerships, trusts, estates, churches, government agencies, Indian tribal entities, certain individuals, and others.) ▶ Go to <a href="https://www.irs.gov/FormSS4">www.irs.gov/FormSS4</a> for instructions and the latest information. ▶ See separate instructions for each line. ▶ Keep a copy for your records.		OMB No. 1545-0003
		EIN		
or print clearly.	<b>1</b> Legal name of entity (or individual) for whom the EIN is being requested			
	<b>2</b> Trade name of business (if different from name on line 1)		<b>3</b> Executor, administrator, trustee, “care of” name	
	<b>4a</b> Mailing address (room, apt., suite no. and street, or P.O. box)		<b>5a</b> Street address (if different) (Don’t enter a P.O. box.)	
	<b>4b</b> City, state, and ZIP code (if foreign, see instructions)		<b>5b</b> City, state, and ZIP code (if foreign, see instructions)	



## Part II – Tax Exemption



## POLLING QUESTION:

*What happens after you've filed your Certificate of Incorporation with DOS?*

- A)** I've created a 501(c)(3) organization, time to start fundraising!
- B)** I've formed a New York not-for-profit corporation and now I'm done!
- C)** Until I apply for tax exemption with the IRS, any money raised or generated by my organization is taxable.



# Tax Exemption

- For most organizations, incorporation is only the first step
- Organizations apply for tax-exempt status because:
  - If not exempt, must pay taxes (business income, sales, real estate, etc.)
  - 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 (Default):** Facts and circumstances reviewed by IRS. Loss of tax-exempt status possible if organization has engaged in substantial lobbying.
  - **501(h) Election:** Establishes bright-line dollar amount an organization can spend on lobbying without jeopardizing tax-exempt status. Opt-in by filing Form 5768. Penalty is excise tax on excess spent on lobbying.



# Lobbying and 501(h) Election

Exempt Purpose Expenditures	Non-Taxable 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) Social Welfare Organizations

- Alternative to 501(c)(3)
- Operated exclusively for promotion of social welfare (i.e., to further the common good and general welfare of the people of the community)
- Purpose may be the same as a 501(c)(3) organization, but permissible methods of achieving the purpose 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 more difficult to fundraise
- Same group may have 501(c)(3) and 501(c)(4)





# Form 1023: Application for Tax-Exempt Status

- **Timing:**
  - Work on Form 1023 can begin immediately, but need certificate of incorporation, bylaws, EIN prior to submission
  - Expect process to take at least several months after submission (as of April 15, 2023, IRS had not yet assigned applications postmarked after September 26, 2022)
  - Effective date of tax-exempt status:
    - Applications filed within 27 months of incorporation: tax-exempt status retroactive to the date of incorporation
    - Applications filed more than 27 months after incorporation: tax-exempt status retroactive to the date of filing Form 1023
- **Application:** Must be filed online at Pay.gov
- **Fee:** \$600



# Form 1023: Overview

- 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

Refer to IRS Instructions!

Form **1023**

(Rev. January 2020)

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](http://www.irs.gov/Form1023) for instructions and the latest information.

**Note:** If exempt status is approved, this application will be open for public inspection.

Use the "?" buttons throughout this form for help in completing this application. For additional help, call IRS Exempt Organizations Customer Account Services toll-free at 1-877-829-5500.

If you cannot complete required responses within the textbox limits throughout this form, upload your additional narratives with the other required documents.

**Part I Identification of Applicant**

**1a** Full Name of Organization (exactly as it appears in your organizing document)

**b** Care of Name (if applicable)

**c** Mailing Address (Number, street and room/suite)

**d** City

**e** Country



# Form 1023-EZ: A Streamlined Alternative

- Eligible nonprofits:
  - Received less than \$50,000 in revenue for each of the past 3 years; **and**
  - Project less than \$50,000 in revenue for each of the next 3 years; **and**
  - Do not have assets whose value exceeds \$250,000
- Other exceptions apply, so consult the worksheet in the Form 1023-EZ instructions for more information
- **Cost:** \$275
- **Application:** Must be filed online at Pay.gov
- **Timing:** Expect between two weeks to two months (as of April 15, 2023, IRS was assigning applications mailed March 30, 2023)



# Public Charity vs. Private Foundation

- Classification depends on source of organization's financial support.
- To be classified as public charity, must demonstrate that a significant portion of revenues (normally at least  $\frac{1}{3}$  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 % of distributions each year



# State and Local Exemptions and Registration

- Once federal tax exemption is obtained, state and local tax exemption applications are straightforward:
  - State Franchise Tax
  - State and Local Sales Taxes
  - NYC Business Corporation Tax
  - Real Property Tax (if applicable)
- Register with NY State Attorney General Charities Bureau (online at [www.charitiesnys.com](http://www.charitiesnys.com)):
  - Prior to beginning soliciting contributions; **or**
  - Within 6 months of receiving property in New York



## **Part III – Annual Filings and Ongoing Compliance**

# Annual Filings (Federal): Form 990

- Annual informational tax form required by the IRS
- Form must be filed by the 15<sup>th</sup> day of the 5<sup>th</sup> 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)
- **If no Form 990 is filed for three consecutive years, the IRS will automatically revoke tax-exempt status**



Form <b>990</b>	<b>Return of Organization Exempt From Income Tax</b>		OMB No. 1545-0047
Department of the Treasury Internal Revenue Service	Under section 501(c), 527, or 4947(a)(1) of the Internal Revenue Code (except private foundations)		<b>2021</b>
	<p>▶ Do not enter social security numbers on this form as it may be made public.</p> <p>▶ Go to <a href="http://www.irs.gov/Form990">www.irs.gov/Form990</a> for instructions and the latest information.</p>		<b>Open to Public Inspection</b>
<b>A For the 2021 calendar year, or tax year beginning</b> , 2021, and ending , 20			
<b>B</b> Check if applicable:  <input type="checkbox"/> Address change <input type="checkbox"/> Name change <input type="checkbox"/> Initial return <input type="checkbox"/> Final return/terminated <input type="checkbox"/> Amended return	<b>C</b> Name of organization		<b>D</b> Employer identification number
	Doing business as		
	Number and street (or P.O. box if mail is not delivered to street address)	Room/suite	<b>E</b> Telephone number
	City or town, state or province, country, and ZIP or foreign postal code		
	<b>G</b> Gross receipts \$		



## 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

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





## Annual Filings (NY State): CHAR500

- Annual report (CHAR500) required by the New York State Attorney General's Charities Bureau
- Must be submitted via online portal within 4 ½ months after the end of the organization's fiscal year

**Note:** Documents filed with Charities Bureau (including certificate of incorporation, bylaws, Form 1023) are made publicly available on the Charities Bureau website.



# NYS Charities Bureau: Annual Financial Reports and Audits

- Additional required financial filings with Charities Bureau depend on organization's income

Annual Gross Revenue and Support	
\$250,000 or less	Unaudited financial report
>\$250,000 - \$1,000,000	Independent CPA review report
More than \$1,000,000	Independent CPA audit report



# Accounting and Financial Reporting Processes & Audit

- Corporations required to file an audit report must have the Board or a designated audit committee comprised only of **independent directors** oversee the corporation's accounting and financial reporting processes and audit
- Board or audit committee must:
  - Annually retain or renew independent auditor
  - Review audit scope and planning with auditor in advance
  - Review the results of the audit and any related management letter with the auditor (including any material risks and weakness in internal controls, restrictions on scope/access, significant disagreements, adequacy of accounting and financial reporting)
  - Annually consider the performance and independence of auditor
  - Report to the full Board (if conducted by audit committee)



## POLLING QUESTION:

*Do you need to file a Form 990 with the IRS every year?*

- A)** No, only once every three years.
- B)** Yes, but only if you have revenue greater than \$50k per year.
- C)** If you file your CHAR-500 with NY State, you do not need to also file the Form 990 that year.
- D)** Yes, every year.



# Unrelated Business Income Tax (“UBIT”)

- Exempt organizations must consider whether they will generate revenue
- An exempt organization can be subject to tax on income if it:
  - Carries on a **trade or business**
  - **Regularly** practiced
  - 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
- Form 990-T used to report unrelated business income to IRS

Form <b>990-T</b>  Department of the Treasury Internal Revenue Service	<b>Exempt Organization Business Income Tax Return</b> <b>(and proxy tax under section 6033(e))</b>		OMB No. 1545-0047
	For calendar year 2021 or other tax year beginning _____, 2021, and ending _____, 20____		<b>2021</b>
	▶ Go to <a href="http://www.irs.gov/Form990T">www.irs.gov/Form990T</a> for instructions and the latest information. ▶ Do not enter SSN numbers on this form as it may be made public if your organization is a 501(c)(3).		<b>Open to Public Inspection for 501(c)(3) Organizations Only</b>
A <input type="checkbox"/> Check box if address changed.	Name of organization ( <input type="checkbox"/> Check box if name changed and see instructions.)	D Employer identification number	
<b>Print</b>			



# Questions?

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