How to Legally Form a 501(c)(3) Organization

Taproot Foundation & TrustLaw

October 2023

taproot

THOMSON REUTERS FOUNDATION

Meet Taproot

Taproot empowers mission-driven organizations by mobilizing skilled volunteers to advance resource equity.

taproot

Emma Hunt

Legal Programme Manager,
North America and the Caribbean

emma.hunt@thomsonreuters.com

THOMSON REUTERS FOUNDATION | TrustLaw

Speaker Bios

Sabrina Glaser, Partner

Sabrina Glaser is a partner in the New York office of Kirkland & Ellis LLP. Sabrina has 15 years of experience advising clients on ERISA matters and currently focuses her practice on ERISA and fiduciary issues in connection with the investment of pension plan assets. Throughout her career, she has maintained an active pro bono practice focusing on the formation, operation, combination and dissolution of nonprofit organizations, including operating charities and schools.

Fariha Syed, Associate

Fariha Syed is an associate in the New York office of Kirkland & Ellis LLP, where her practice focuses on Debt Finance and corporate transactions. Her pro bono work focuses on nonprofits, immigration matters and small businesses.

Agenda

1. 501(c)(3) – Overview and Advantages/Disadvantages
2. Steps to Forming a 501(c)(3)
3. Alternatives
4. Q&A

What is a 501(c)(3)?

Overview

501(c)(3) is a tax-exempt status under the US IRS for nonprofit organizations

To qualify, your organization must be:

- organized and operated to benefit a certain segment of people or community,
- not created for the purpose of generating a profit,
- and for one or more of the following exempt purposes:
  - *religious*
  - *charitable*
  - *scientific in the public interest*
  - *literary/educational*

Advantages & Disadvantages

Advantages

- Don’t have to pay federal income tax
- Based on your state, might be able to avoid certain state and local taxes
- Any donations are tax deductible to the giver
- Eligible for exclusive public and private grants
- Cannot be personally liable for any debts incurred by your organization

Disadvantages

- Timely and expensive
- Subject to public scrutiny
- Government restrictions and regulations
  - restrictions on some type of political activities
  - restrictions on how D&Os are paid
  - have to track every activity and money transfer in case of an audit

Steps to Forming a 501(c)(3)

Step: 1 2 3 4 5 6 7 8 9 10 11

Form a not-for-profit corporation in the applicable state

Forming a new entity	Converting your LLC to a corporation	Existing corporation
File the Articles of Incorporation	File a certificate of conversion and pay a filing fee If your state doesn't allow a statutory conversion, undergo a statutory merger	Skip to step 4

Form a not-for-profit corporation in the applicable state

File the Articles of Incorporation

- Pick a name
- Select a registered agent and office
- Appoint your board of directors

Fiduciary Duties of Directors:

- Duty of Loyalty
- Duty of Care
- Duty of Obedience

Step: 1 2 3 4 5 6 7 8 9 10 11

Form a not-for-profit corporation in the applicable state

File the Articles of Incorporation

The IRS will review your articles of incorporation/association, charter, trust document or by laws and use the **organizational** and **operational** tests to determine whether your organization is truly organized and operated for a specific exempt purpose

Organizational Test:

- The document must limit the purpose to one of the exempt purposes (religion, education, science, etc.),
- Contain a clause describing the main activity that will accomplish the purpose
- Prohibit earnings to private shareholders/individuals, prohibit illegal activities, limit legislative activity, and
- Contain an acceptable dissolution clause (how the assets of the organization will be distributed in the event of a dissolution)

Purpose (important!) – doing this correctly will avoid a lot of problems later

Step: 1 2 3 4 5 6 7 8 9 10 11

Form a not-for-profit corporation in the applicable state

File the Articles of Incorporation

Operational Test:

- The organization must be primarily engaged in activities that accomplish one or more of the exempt purposes. Must serve a public, not private, interest
- Net earnings cannot benefit private shareholders/individuals
- No substantial involvement in influencing legislation
- No participation in any political campaign

Assign an incorporator:

This person will sign the Articles. Must be 18 years or older, or a corporation. Can have more than one if desired

Once the Articles of Incorporation are filed, you have created an entity. The next step is to obtain tax-exempt status.

Step: 1 2 3 4 5 6 7 8 9 10 11

Obtain a federal employer identification number (EIN)

A 9-digit number assigned to entities for tax filing and reporting purposes

Apply for one using Form SS-4

Need this to open business bank accounts and to file for tax-exempt status

Be prepared with the following:

- *Entity's legal name*
- *Responsible party name*
- *Applicant's SSN or ITIN*

Step: 1 2 3 4 5 6 7 8 9 10 11

Draft the Bylaws

The document that informs how the organization will operate	Opportunity to set any guidelines and clarify who has power to make decisions	Structure – member/non-member
Fiscal Year Start (any 12-month period). Commonly January 1 or July 1. Determines when you will file your annual reports with the IRS and the state attorney general	How often the board will meet and any notice requirements	Responsibilities of any officers (i.e. President, VP, Secretary and Treasurer) appointed by the board of directors. Set a reasonable term (1 to 3 years). Specify how they can be removed (with or without cause, by vote, etc.)

Membership

- Common for nonprofit organizations which focus on advocacy
- State laws generally confer voting rights on the members. Allows them to participate in corporate decision-making
- Can elect board members
- Approve/reject changes to the Articles of Incorporation or bylaws
- Vote on major corporate changes such as mergers or dissolution
- Compliance with regulations that protect each member's right to vote

Non-Membership

- Common for nonprofit organizations which provide services
- Instead of members, the board of directors participate in corporate decision-making
- New directors are elected or appointed by existing directors

Adopt a conflict-of-interest policy

Highly recommended. Some states require this in the bylaws

Occurs when the aims of the organization and the aims of another party are incompatible and when advancing one's interest is more important to the individual than advancing the goals of the organization

Might get flagged by the IRS if it looks like you are operating like a for-profit entity or benefitting individuals involved in your organization

Excess benefit transactions – regulated under 4958 of the IRS Code. Occurs when a tax-exempt organization delivers an economic benefit to an insider that exceeds the fair market value of what the organization receives in return by overpaying for a good or service. If this occurs, then the excess benefit transaction will be subject to excise tax by the IRS and the disqualified person would be liable for the tax.

See Appendix A of Form 1023 for an example

Form 990 and Forming a Compensation Committee

Complete Form 990 annually once you obtain 501(c)(3) status

Provides the public with financial information of your organization

Have to disclose revenues, expenses, assets and liabilities

Threshold – must file if your gross receipts are at least $200,000 or assets are worth at least $500,000. If you are under this threshold, can file a shorter form called 990-EZ

IRS uses this to determine whether you will still qualify for tax-exempt status

If IRS determines that management is over-compensated, you can lose your status

Form 990 and Forming a Compensation Committee

Helpful to form a compensation committee to avoid losing your status, but not required. If you have no paid employees, no need for this committee

Form 990 does ask whether compensation arrangements are reviewed and approved by disinterested directors or a compensation committee

The committee can review the compensation of your D&Os, employees, independent contractors, etc.

The committee can make sure that the compensation is reasonable and tied to the achievement of mission-related goals

The committee will consist of unpaid directors

Adopt a Whistleblower Policy

Not required, but Form 990 will ask if you have one

Encourages people to report wrongdoings, such as illegal practices or violations of policies

There will be a specified person responsible for handling the reports, such as a compliance officer

Policy should protect the reporting person from retaliation and detail the procedure for investigations

D&Os and employees should sign a statement that they received a copy of the policy, read, understood and agreed to comply with the policy, and understood that the organization is a charitable organization that must engage in activities that accomplish its exempt purposes to maintain tax-exempt status

Step: 1 2 3 4 5 6 7 8 9 10 11

Adopt a Document Retention and Destruction Policy

Not required, but Form 990 will ask if you have one

Ensures that documents are retained pursuant to applicable laws

Ensures that documents relevant to legal or governmental proceedings are not destroyed

Policy should identify who is responsible for maintaining the storage and destruction

Best to keep permanent records of:

- *accounting records*
- *donations (both cash and non-cash/in-kind gifts)*
- *Articles of Incorporation, bylaws, amendments, corporate annual reports, board meeting minutes, and*
- *activity records (fundraisers)*

Hold the First Organizational Meeting

- The initial meeting where the formalities of the corporation are determined
- Doesn't have to be in person and can be documented through a written consent if permitted under state law
- If your Articles of Incorporation did not establish your board of directors, or you want to change them, this is your chance to do so
- Can also appoint officers and establish any committees or policies discussed before
- Adopt your bylaws
- Important to approve any resolutions, such as opening the organization's bank account and authorizing applications for federal and state tax-exempt status

Apply for Federal 501(c)(3) Status

Complete Form 1023, Application for Recognition of Exemption

Instructions are on the IRS's website with explanations for each line

Must electronically file

Note that this form is public

May be eligible for Form 1023-EZ if your gross income was under $50,000 in the past 3 years and estimated to be less than $50,000 for the next 3 years

Once you obtain the IRS determination letter, your organization is tax-exempt

Register as a Charitable Organization with the State Attorney General

- Required/recommended to register
- Might need to register in other states where you may raise funds

Apply for Other State and Local Tax Exemptions

- Once you have the IRS determination letter, you can apply for tax exemptions at the state and local levels such as income tax exemption, sales tax exemption and/or property tax exemption
- May be procedural requirements to follow based on the state

Alternatives

Alternatives to a 501(c)(3)

Informal Groups	▸ Volunteer and donate money collectively to organizations that further your common goal
Work with an Existing Organization	▸ There are many nonprofit organizations that may already exist that further your common goal
Work with a Social Enterprise	▸ A mission-driven, for-profit business that uses its resources to support a good cause. Many companies donate some of their profits to a good cause
Partner with a Fiscal Sponsor	▸ An established nonprofit organization with recognition of income exemption from the IRS. The FS works with another entity so that entity can begin its activities and be funded by charitable donations, often by helping to facilitate receiving financial support from potential donors ▸ Pros: can apply for an receive grants and tax-deductible donations through the sponsor ▸ Cons: acts of the org must match the purpose/acts of the FS. FS might charge a fee. Org must comply with the FS's requests. Funds received are under the control of the FS

CONTACT TRUSTLAW

THOMSON REUTERS FOUNDATION

Please reach out

emma.hunt@thomsonreuters.com

taproot

Questions & Answers

help@taprootplus.org