

Starting a Nonprofit Organization

A guide to starting a nonprofit
organization with details on
incorporating and filing for tax
exemption

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Introduction

Congratulations! You have made the first giant step in starting a new nonprofit organization. You have decided to turn a good idea into a real project. Now it's time to get to work and put those ideas into action. This manual will guide you in the right direction on matters such as setting up a board, getting technical assistance, incorporating, and filing for tax exemption. There are many books and sources of information that will help you with these and other questions. Use as many of these sources as possible; you can never know too much about how to set up your organization and there is no substitute for knowing it yourself.

Community Accountants sincerely thanks Richard Bove, JD, CPA of Coopers & Lybrand for his review of this manual.

Community Accountants provides accounting-related services through volunteers to help Delaware Valley nonprofits and small businesses become self-sufficient. Services include direct service, workshops, board member referral, hotline, and publications. For more information about our services please call (215) 951-0330 ext 125.

To help get you in the right frame of mind, Joan Flanagan lists the following "Do's" in her book, *The Successful Volunteer Organization*.

DO set clear goals with tangible results

DO have a timetable for reaching those goals

DO start raising funds and building a support network right away

DO recruit members and volunteers that have skills that you need to run your organization properly

DO set up and organized bookkeeping system right away

And one DON'T: DON'T GIVE UP

Note: This publication is intended as a guide and is not a substitute for professional accountant or legal services. In addition, it does not reflect changes in the laws, regulations, tax rates and the like occurring after its publication.

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Getting Started

Getting your new nonprofit rolling will be much easier if you start by addressing three critical issues. You need a purpose, you need a plan, and you need people.

A Purpose may sound almost too basic to discuss, but the importance of having a clear, concise statement describing the mission of your organization cannot be overemphasized. Everyone you deal with- funding sources, coulter, board members, the IRS- will want to know what your organization does. The purpose must be clear and simple, reflect the goals of your group and yet allow room for growth and some diversity. You will find that, as you become involved with all the little daily details of running an organization, it is helpful to have a mission statement to remind you and your partners of why you got started in the first place!

The next step is to write a plan for your organization. You know what goals your group wants to reach but you need to map out how you are going to work towards these goals.

Joan Flanagan simplifies the planning process by asking the basic news story questions: Who? What? When? Where? Why? How? And a new one How much?

WHO means making one list of the people who share the groups' interests and goals and another list of people who possess the skills and contacts you will need to run the organization. Think how you can best use these people as you work on the plan.

In addition, make a list of people who will oppose your plan and decide how they will affect the success of the group. Now is the time to anticipate problems so you can incorporate the solution in to your plan.

WHAT is answered by your purpose? Take those general goals and break them down into specific tasks. Make these tasks measurable by using dates and numbers so you know when the tasks are completed.

WHEN requires a calendar showing all events, activities, due dates and goals for the next year.

WHERE means where your group will meet and also where you will do your work. For example, a historical society may have monthly meetings at a member's home but it may be renovating a historic home at a different location.

WHY is answered in your purpose. IT is important to be able to spell out the reasons for your group's existence so you can explain them to others.

HOW are the activities you will organize going to meet your goals.

HOW MUCH means putting down the dollars and cents of carrying out your plans. You will have expenses from the moment you begin and you need to keep track of them and find a way to pay them. Two things need to be done immediately. First, ask for money from the people who want and need your group. Second, find a responsible person to keep track of the income and expenses and ask him or her to prepare a monthly report of the groups' finances.

Once you have written down the answers to these questions, you will have a plan to keep you moving in the direction of your goals.

The third step is to recruit the people needed to run your organization. We are all familiar with the people who start and seem to run organizations single-handedly, but in reality these people have a large support network backing them up. Look for two specific groups of people to work with you. First, develop a group of dedicated supporters who will serve as the board of directors. Second, find volunteers to help run the program.

Board of Directors

The board of directors is responsible for making decisions for the organization. Legally, it is responsible for the governing of the organization and for its adherence to state and federal laws. Typical boards have from seven to 21 members and are made up of officers who have specific responsibilities (President, Vice-President, Secretary, and Treasurer) and others committed to the group, who make decisions as a team. The theory behind establishing a board of directors is that a group is likely to make correct decisions more often than any one individual.

When setting up a board, many people recommend recruiting board members who fall into one of three categories.

Wealth: Those that can support you with money

Work: Those who will volunteer their time and talents

Wisdom: Those who have expertise in areas you do not

Of course, the ideal board member is dedicated to your purpose, raises funds, recruits volunteers and members, works hard, and is enthusiastic. In reality, there are very few people who meet all the criteria. Your goals should be to develop a board that, as a whole, encompasses all the needed qualities.

While you may be tempted to try and attract prominent community leaders or celebrities to your board because they have something special to offer the group, it may be better to wait until you are a more established organization. These individuals tend to be in demand and while they may be very committed to your purpose, they may have a limited amount of time

and energy to devote to your organization. If you want to get three people involved immediately, set up an advisory council. This council will not have the governing responsibilities of the board but will be available to assist in certain areas of the expertise such as offering legal or financial advice or in arranging special fundraising events.

Whatever you do, never turn away anyone who shows an interest or a willingness to help. Keep in contact even if you don't have an immediate place for them. At some point in the life of your organization, you will need their help.

Volunteers

One group of people you need to recruit immediately are professionals willing to volunteer their time. These professionals include an accountant and a lawyer at the very least. Bankers, insurance agents, marketing specialists, and others should be contacted as the need arises.

There are many sources available in which to find professional volunteers. Start with friends and relatives of yourself and your board members. In some cities, there are organizations that specifically provide professional services to the nonprofit community (see appendix 1). Professional societies and associations usually have a community relations representative responsible for projects that help community groups. Identify these people and let them know how they can help your group. Make sure it is very clear you are looking for volunteer services and then, once you have found volunteers, remember that the services are FREE, or provided at a greatly reduced fee. Do everything you can to make the volunteer's job

easier including being on time, preparing in advance for meetings, and regularly sending thank you notes.

Working with volunteer professionals and board members is rewarding for everyone. You learn new skills that can help you meet your goal, the professional get the satisfaction of helping a community group and the community gets the competent organization.

Incorporation and Tax Exemption

If you are planning to initiate programs and raise money to support programs through your organization, you will need to become a tax-exempt organization. You may choose to be a trust or a non-profit corporation. General, a corporate form is the most preferred form of tax-exempt organization. These steps make your organization a separate legal entity (Corporations, Trust, or Association) and permit you to operate without paying income taxes to the IRS (tax exemption). In addition, donations to many tax-exempt organizations give some contributors deductions on their income tax form.

Bylaws

Once you have written a plan for the group and have elected a board of directors, the next step is to write bylaws. By laws are the rules by which your organization will run and are helpful when filing for incorporation? Bylaws include information such as the name and purpose of the group, who

can become a member and how, when meetings are held, what officers are needed and how they are chosen, duties and terms of the officers and other rules needed to conduct business

Bylaws should be written by a committee of three or four and presented to and approved by the board of directors. When writing bylaws there are a few rules to keep in mind:

1. Use Simple language and few words but clearly describe the meaning of each rule.
2. Do not write any rules that are illegal
3. Make sure the rules are reasonable for your organization

Sample bylaws are in Appendix 3. These bylaws can be used as a model, but should not just be copied without considering whether they are appropriate for your organization and whether your organization needs additional bylaws.

You should always have bylaws drafted when you incorporate or shortly thereafter. Incorporation establishes the organization as a unique legal entity in the state in which it operated. You cannot file for tax exempt status with the IRS until you are incorporated or formed as a trust or association, most organization choose to incorporate. Advantages of incorporations and tax exemptions are:

1. Limited legal liability. The members of the group are not liable for corporate debts, only the organization itself is liable but directors can be liable for certain misdeeds as an officer. D&O insurance may cover some liability.

2. Tax Exemption. No corporate income taxes need to be paid other than a special tax on “unrelated business income.”
3. Tax deduction. Some contributors to tax exempt organizations can deduct these contributions on their federal income tax return.
4. Increased funding base. Most government agencies, foundations and corporate funders require that you have tax-exempt status in order to receive their grants.

Articles of Incorporation

In Pennsylvania and most other states, incorporation involves filing articles of incorporation with the state. Contact the secretary of state and ask for all forms, instructions, and sample articles of incorporation.

It is a good idea to file your articles of incorporation in a way that will be acceptable to the IRS when you file for your tax-exempt status (i.e., refrain from all political activity, limit lobbying activity, upon dissolution assist to other 501C. Get a copy of IRS Publication 557, Tax Exempt Status of Your Organization from the IRS (for ordering forms, see phone number at the end of this manual). This publication describes how the IRS wants you to fill out your articles of incorporation.

Sample articles of incorporation are in Appendix 4. These, too, can be used as a model, but should not be used without considering the specific needs of your organization.

Types of Tax Exempt Organizations

The first step is to make some decisions about which categories the organizations will fit into for IRS purposes. At the back of Publication 557 there is a list of types of tax-exempt organizations and what groups fall into each section of the tax code. In most cases your group will fall into either the 501(c)(3) or 501 (c)(4) category.

Generally, 501(c)(3) organizations are those that are organized for charitable purposes. These purposes include charitable, educational, religious, scientific, literary, testing for public safety, fostering amateur sports competitions or for the prevention of cruelty to children and animals.

The organization must exclusively engage these purposes. Creators of tax-exempt organization cannot benefit directly or indirectly from the earnings of a tax-exempt organization. These tax-exempt organizations are entities, which are autonomous and are public entities.

501 (c)(4) organizations are organized exclusively to promote social welfare. The main difference between 501(c)(3) and 501 (c)(4) organizations is that (c) (3) organizations can spend up to 20% of their budgets (not to exceed their budgets) for lobbying. A second difference is that contributions to 501(c)(3) organizations are deductible on some donors' tax returns; contributions to 501(c)(4) organizations are not.

Unless your group obviously falls into one of the other 501(c) groups it will probably be a (c) (3) or (c) (4). Since this is a complicated area and one where the rules change from time to time, it is probably best to check with your attorney or someone experienced in these areas.

IRS Requirements within the Articles of Incorporation

1. The IRS wants to know about your purpose, profits, lobbying and assets. All this information comes from the purpose section of the Articles of Incorporation. You should read Publication 557 for specific guidelines on how to work this information
2. The IRS wants to know that the group is organized and exclusively for one of the purposes (charitable, religious, etc.) mentioned earlier.
3. If you have any net income or profits from the business of your group, the IRS wants to know that this “profit” will be used for the specific purpose listed previously.
4. The IRS wants to know how much lobbying your group plans to do. Although not every nonprofit group participates in lobbying activities, for those who do, the IRS wants to know all the financial details. This issue should be discussed early in the formation of your group.

The IRS recognizes two types of lobbying: grass roots lobbying which influences public opinion and, therefore, legislation officials and employees or legislators. Briefly, the IRS will allow tax-exempt organization to spend up to 20% of the first \$500,000 in total expenses on lobbying. If you spend more than this limit the excess expenses are subject to a 25% excise tax. If you spend more than 150% over the limits for four years you will likely lose your tax-exempt status.

Discuss with your attorney and your board how much, if any, lobbying you plan to do and file form 5768, *Election/Revocation of Election by an Eligible Section 501 (c) (3) Organization to make expenditures to Influence*

Legislation. Publication 557 describes in more detail the lobbying rules and limitations.

5. Finally, the IRS wants to know that if you go out of business or dissolve, all the assets (money, furniture, equipment, etc.) will be transferred to another 501 (c) (3) organization. This assures the IRS that you are not taking advantage of the nonprofit status to set up a profit making company. Most states require this provision before they will allow you to incorporate as a nonprofit corporation.

When you file your incorporation papers, you will receive a corporate seal and some official forms. Keep these in a safe, accessible place.

Tax Exemption- Filing Form 1023

If you have decided to file for tax exemption under section 501 (c) (3), get a copy of IRS Form 1023 *Application for Recognition of Exemption*. If you fall into one of the other categories, consult Publication 557 for the requirements for your type of group. You will most likely file Form 1024. The following sections refer to Form 1023 and will be clearer if you have it in front of you as you read along.

At first glance, Form 1023 may appear overwhelming, but once you have read through the questions and eliminates all the pages that do not apply to your group, it become a more manageable task. Publication 557 gives some specific guideline on how to answer the questions,. Make sure

you read the questions carefully and answer them completely in the terminology used by the IRS.

Parts I and II of the Form 1023 ask you who you are, what you have done and what you are going to do. Since you have, already put together a plan, filing out this part of the form should go fairly well.

Part III involves technical requirements,. The first question asks how much time has passed between your incorporation and the filing of Form 1023. If more than 15 months have passed, the organization needs to meet a number requirement for the nonprofit status to be retroactive to the incorporation date. Particular is it has been more than 15th months; it may be best to consult with an attorney concerning your options in filing for nonprofit status.

Public Charity Vs. Private Foundation

The IRS considers an organization to be a private foundation unless it falls into a category specifically excluded from private foundation status. These excluded categories are describes in detail in Chapter 3 of Publication 557. They are known as section 509 (a) (1), (2), (3), or (4) organizations,. Carefully read the sections describing the excluded categories and determine where your organization qualifies. If none of the 509 (a) categories describe your organization, then it will be considered a private foundation.

If you are private foundation, you next need to determine if you are a private operating foundation. Private operating foundations are similar to private foundations in many ways. There are advantages to becoming a private operating foundation such as excise tax exemption. Again, Publication 557 lists the conditions under which your organization may

qualify for private operating foundation status, this is a difficult section due to the terminology used by the IRS and you may need to consult with your attorney and accountant before completing it.

Advance Ruling vs. Definitive ruling

If you determine that your organization is of a private foundation because it fits into one of the 509 (a) categories, you must decide whether you will apply for a definitive ruling or an advance ruling. The IRS will not issue a definitive ruling of nonprofit exemption to an organization that has an initial operation year of less than eight months.

If you are a brand new organization, you must apply for an advance ruling. The IRS will issue a temporary nonprofit exemption ruling (advance ruling) that applies for five years. Under an advance ruling, you may operate for this period of time as a nonprofit organization. At the end of the advance-ruling period, the IRS will request some additional information about the organization and, if there are no changes in the operations that will affect your nonprofit exemption eligibility; you will be issued a permanent or definitive ruling.

If you are requesting a definitive ruling, you will have to prove to the IRS that you are not a private foundation by specifying the basis for your claim of non-private foundation status. This will determine the specific schedules you must then complete. Again, you may need to consult your accountant if you are required to complete these sections.

If you are applying for an advance ruling, you must also fill in Form 872-C in the back of the 1023 package. This form allows the IRS to impose

an excise tax on investment income earned during the advance ruling period if it is determined that the organization is a private foundation.

Part IV, the final section of the form, asks you to submit financial statements for the current year and for each of the three years immediately before it. If your organization has existed less than four years, complete the statements for each year in existence, If it has existed less than one year, you need to submit budgets for the next two years. Your accountant should be able to help put the financial information together in the right format.

Along with the application for tax-exempt status, be sure to include the required fee and Form 8718. Request for tax exempt status under section 509 (a) (except a section 401(a) trust) by an organization whose gross receipts have not exceeded (or are not expected to exceed) \$10,000 annually, averaged over its first four taxable years, must include a user fee check of \$150. All other requests for recognition of tax-exempt status under section 501 (a) or 521 (except a section 401 (a) trust) must include a user fee of \$465. A private foundation which has completed a section 507 termination and which seeks a determination letter that it is now a public charity, must include a use fee of \$200.

Processing Form 1023

Carefully review the 1023 application form and also ask your attorney and accountant to review the form. Any omissions or errors will increase the amount of time it takes the IRS to approve the application or could even result in a denial of the application. Use the checklist included in the 1023 package to make sure you have included all the proper information. Sign and mail the form to the correct address and keep a copy in your files.

If you do not hear from the IRS office within three months, call the local IRS office and ask for the number for tax exemption information. In some cases, the applications do not reach the proper departments and you will have to mail another copy. Keep in touch with the IRS to assure that your application will be processed properly.

If your application is accepted, you will receive a determination letter from the IRS recognizing your tax-exempt status. If you applied for an advance ruling, the letter will state the date your advance-ruling period ends, what your accounting year is and who to contact at the IRS with questions. If you requested a definitive ruling you will receive the same type of letter stating that you have received nonprofit status. **DO NOT LOSE THESE LETTERS.** Funders and other organizations will often want to see proof for the IRS that the group is a 501 (c) (3) organization and you will need to send them a copy of the determination letter. Send a copy, never the original letter. It is a part of your permanent records and should be kept with your incorporation forms and seal. In addition, you will need to retain these documents for your public disclosure requirement (Form 990, 1023, and Articles of Incorporation).

If your application is rejected you will receive a “proposed adverse determination letter” denying the exemption. The board has 30 days to appeal to the Regional Director of Appeals. Follow the appeal procedures in *Publication 557 and Publication 892 Exempt Organization Appeal Procedures for Unagreed Issues*. Check with your attorney and quickly (you only have 30 days) take the proper actions.

In addition to IRS requirements, many states, including Pennsylvania and New Jersey, require nonprofit organizations to file annual reports. Check

with your state to determine what is required of your organization. Contact numbers for Pennsylvania and New Jersey are listed in the appendix.

The steps to becoming a nonprofit organization may appear overwhelming, picky, and sometimes ridiculous, but the results are worth the time it takes to get nonprofit status. Once you receive a ruling from the IRS, thank all the volunteers who helped with this step, and congratulate yourself!

Alternatives

There are some groups who may not benefit from or may not be able to get tax-exempt status. To follow are some alternatives. You should consult with an attorney to determine if any of these would be more advantageous for your group.

1. **Do not organize.** As long as you are not doing any solicitation for funds, you can remain an informal group. While this is an attractive alternative because there are no filing requirements, your resources are severely limited.
2. **Become part of your group that is already tax-exempt.** In this case you have the advantage of an established organization's knowledge and resources,. You may be restrained by the larger group's limitations but you can always break off into a separate group later.
3. **Become a different type of nonprofit.** You may be able to organize as a cooperative or an association. Check with your state or your attorney for details on how to organize as one of these entities.
4. **Become a "for profit" organization.** If you think your group can support itself by charging for its services, this may be a good choice. The advantages are that you can lobby, make money, and do not have to stick to a specific mission or purpose.
Disadvantages are that you cannot solicit donations or funding to support yourself and you have to pay taxes on any profits generated by the business.

Congratulations! You have completed the process for becoming a nonprofit organization. Now you can begin your operations, work towards your goals and raise funds.

Resources

These resources are in the Philadelphia area. Other areas may have similar organizations:

Community Accountant: 3721 Midvale Avenue, Philadelphia, PA 19129. (215) 951-0330 ext 125. Provides free accounting-related services to help nonprofits become self-sufficient

LaSalle University Nonprofit Management Development Center: Philadelphia, Pa 19141. (215) 951-1454. Provides core training program for nonprofit executive directors and board members through peer support groups specialize workshops, individualized management support, board placement, and graduate courses.

Nonprofit Technology Resources: 437 Poplar Street, Philadelphia, Pa 19123. (215) 922-0227. Provides computer training and support.

Philadelphia Volunteer Lawyers for the Arts: 251 South 18th Street, Philadelphia, PA 19103. (215) 545-3385. Provides legal assistance to arts groups that qualify for services.

Regional Foundation Center: Free Library of Philadelphia, Logan Square, and Philadelphia, PA 19103. (215) 686-5423. Reference center materials include information on corporate and foundation giving, fundraising grantsmanship, nonprofit management, and philanthropy.

Where to get and mail forms

Federal Forms

To Order: Forms Distribution Center
P.O. Box 25866
Richmond, VA 23261
(800) 829-3676

Philadelphia Area, mail to:

Internal Revenue Service
Philadelphia, PA 19255
(215) 574-9900

Pennsylvania State Forms

Bureau of Charitable Organizations Registration:

Commonwealth of Pennsylvania
Department of State
Bureau of Charitable Organizations
308 North Office Building
Harrisburg, PA 17120
(717) 783-1720

Incorporating:

Commonwealth of Pennsylvania
Department of State
Corporation Bureau
P.O. Box 8722
Harrisburg, PA 17105-8722
(717) 787-1057

Sales Tax Exemption:

Department of Revenue
Bureau of Business Trust Fund taxes
Registration Division
Department 280901
Harrisburg, PA 17128-0901
(717) 787-8201

New Jersey State Forms

Division of Consumer Affairs
Charities Registration Section
124 Halsey Street
Newark, NJ 07102
(201) 504-6200

Model Bylaws

The following bylaws are presented in a generic form that can be adapted to the needs of individual organizations. You do not have to use all these articles and you may ass as many as needed to properly run your organization.

Consider the needs and goals of your organization before adopting bylaws, and consult with your attorney and accountant during the process. There are a wide variety of options regarding membership, governance, etc.. and these professionals can help your organization make the most of the options.

Article 1: Name

The name of this organization shall be:

Article 2: Purposes

The purpose of this organization is :

1. To promote the development of:
2. To assist members to achieve:
3. To make scholarships available to:

Article 3: Membership

If a membership organization

3.1 Types of membership shall consist of active and honorary membership.

- a. Active membership requires that the member be:
- b. Honorary membership may be conferred upon an individual provided...and is chosen by the executive board for such honor. Such member is entitled to the same privileges as an active member.

3.2 Qualifications for admittance to this organization are:

3.3 Application for membership must be sponsored by two members in good standing of the organization.

3.4 Annual dues shall be.... Payable to the Treasurer not later than...each year.

3.5 A member who resigns in good standing (dues paid up to date) may reapply for membership within a period of...

If a non-membership organization:

3.1 The Corporation shall have no members.

3.2 The Directors may create such classes of “membership,” such as contributing members or honorary members, as the Directors see fit, but such persons shall not have the rights of members under the Pennsylvania nonprofit Corporation Law of 1988, as amended (the “Act”).

Article 4 Board of Directors

- 4.1 The board shall consist of the elected officers and the appointed committee heads
- 4.2 The board shall handle the regular business of the organization.
- 4.3 Meeting. Regular meetings of the executive board shall be held...
- 4.4 Quorum. A quorum for conduction the business of the executive board shall be not less than...members of the board empowered to vote.

Articles 5 Officers and Committee Chairpersons

- 5.1 There shall be the following elected officers.
 - a. President
 - b. Vice President or Vice Presidents
 - c. Recording Secretary
 - d. Corresponding Secretary
 - e. Treasure
- 5.2 An officer who does not comply with assigned responsibilities may be relieved of office by majority vote of the executive board. The president with the approval of the board shall make appointment of a replacement.
- 5.3 The head of committees shall be appointed by the President immediately after installation.

Article 6 Elections

- 6.1 a. Nominations. A nominating committee consisting of a chairperson and two members shall be elected at the time of regular elections. At the end of the term, their duty is to nominating committee for the next administration.
- b. Report of the nominating committee shall be made at the (date)...meeting.
- c. Nominations from the floor will be in order at the...meeting.