

# THINKING OF STARTING A NONPROFIT?

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# FOR-PROFIT OR NONPROFIT?

Key questions:

- ◉ Who benefits?
- ◉ What is its purpose?
- ◉ Is it needed?
- ◉ How is it funded?
- ◉ Who runs it?

WHO BENEFITS?

# WHO BENEFITS?

- ◉ In the nonprofit, the public benefits.
  - Or a large, indefinable subset of the public
- ◉ For a charity (so-called 501(c)(3) organization), a “charitable class” must benefit; for example:
  - The needy
  - The elderly
  - The residents of New Bedford
- ◉ One person cannot be a charity.

# WHO BENEFITS?

- For other tax-exempt organizations, specific groups may benefit; for example:
  - Social Club, whose members benefit from its programs & activities.
  - Trade Association, businesses who are members will benefit.
- Benefits need not be financial; they can be intangible, or property.
- Public benefit leads to public availability of financial reports (IRS Form 990).

WHAT IS ITS PURPOSE?

# WHAT IS ITS PURPOSE?

## For-profit:

- ⦿ Can have any purpose it chooses.
- ⦿ Articles of Organization will state its purpose as “all things lawful”.

## Nonprofit:

- ⦿ Must specify an *exempt purpose* to be tax-exempt;
- ⦿ Under MA state law, nonprofit purposes are broader.

# WHAT IS ITS PURPOSE?

## Exempt Purpose:

- ◉ Purpose specified in statute, case law, or IRS ruling.
- ◉ 501(c)(3)
  - Statutory:
    - Charitable, educational, religious, scientific, literary, etc.
  - Other sources of law provide for purposes like museums, and arts and culture, community development.



# WHAT IS ITS PURPOSE?

## ◉ Other tax-exempt purposes:

- Social clubs must have a social purpose—people come together to socialize.
- Trade associations must serve common business purposes.
- Advocacy organizations must have a social welfare purpose.

Bottom line: the nonprofit's purpose must fit into statutory or other specific purpose.

# WHAT IS ITS PURPOSE?

The nonprofit's activities must be *in furtherance of its exempt purpose*.

- ◉ Virtually all (“substantially all”) its activities must be directly related to the exempt purpose.

Example: A food pantry has an exempt purpose to “feed the needy”; an activity “in furtherance” might be to deliver groceries to needy peoples’ homes.

In other words, what will it DO?

# WHAT IS ITS PURPOSE?

- Too much unrelated activity may subject the nonprofit to tax (“unrelated business income tax”), or denial or loss of tax-exempt status.
- Activities that are “commercial in nature” may be found to be unrelated to exempt purpose.
  - So-called “Commerciality Doctrine”.
  - Activities that are too similar to those of business for profit.
  - Operations too similar to commercial business.

IS IT NEEDED?

# IS IT NEEDED?

- ⦿ Thousands of nonprofits already exist, and all seek the same charitable dollars.
- ⦿ Many provide similar or even identical services.
- ⦿ Essential to conduct needs assessment.
- ⦿ What will make your organization unique?
- ⦿ Will another path allow you to achieve your goal, without starting a new nonprofit?
  - Can you volunteer with another existing organization?
  - Can you create a program within another existing organization?

HOW IS IT FUNDED?

# HOW IS IT FUNDED?

For-profits are funded by:

- ◉ At start-up, often by the owners, out-of-pocket;
- ◉ Investors may provide cash in exchange for an ownership interest; e.g., shareholders;
- ◉ Debt financing;
- ◉ “Angels”;
- ◉ Only limited availability of grants for business, usually governmental (e.g., Workforce Training Fund);
- ◉ And of course, profits.

# HOW IS IT FUNDED?

## Nonprofits:

- ◉ Charities are funded (“supported”) by the public; e.g. fundraising, grant-seeking.
- ◉ Other tax-exempts are generally funded by their members; e.g., dues payments.
- ◉ Some nonprofits are funded by fees for services.
- ◉ “Seed money” and loans are seldom available to nonprofit start-ups.
- ◉ Established nonprofits may take on debt.



# HOW IS IT FUNDED?

Fundraising must be sustainable to sustain the organization.

- ◉ Private donors; private giving is:
  - more reliable than other fundraising;
  - More cost-effective;
  - Relationship building essential to success.
- ◉ Grants
  - Excessive pursuit of grants leads to mission drift.
- ◉ Events
  - Time-consuming, labor-intensive, low ROI
  - Must have goal beyond simply raising money.

WHO RUNS IT?

# WHO RUNS IT?

For-profit is run by its owners, or those designated by its owners; for example:

- ◉ Owners personally, as in sole proprietorship, partnership.
- ◉ Board of Directors (corporation)—but one person—the owner—may be the entire board (in MA).
- ◉ Members (LLC) or managers (manager-managed LLC)

# WHO RUNS IT?

Nonprofits are always run by a board of directors. The board has complete authority over the nonprofit. Nonprofits have no owners.

- ◉ To be recognized as tax-exempt, the nonprofit must have a board of several people.
- ◉ No one person may control the nonprofit.
- ◉ Directors are generally uncompensated volunteers.
- ◉ Independent directors essential.

# WHO RUNS IT?

- ◉ Boards may delegate some of their authority to staff—in larger organizations, typically day-to-day operations;
- ◉ They may not delegate away all of their authority.
- ◉ The board is always ultimately responsible for all activities of the nonprofit; oversight is key responsibility.

# WHO RUNS IT?

Building the initial board of directors is critical first step. Look for people who:

- ⦿ Share your passion for the mission;
- ⦿ Can commit to attending meetings;
- ⦿ Willing to be hands-on through start-up phase;
- ⦿ Bring good brain power, independent thinking.

But avoid focusing your search on family members and work colleagues.

# WHO RUNS IT?

Who should NOT be on your board?

- ⦿ Anyone hesitant when it comes to your mission.
- ⦿ People who don't have time to attend meetings.
- ⦿ People unwilling to share ideas or opinions, or who are unwilling to listen to other's ideas or opinions.

These points eliminate some people, for example:

- ⦿ Politicians
- ⦿ High level community leaders
- ⦿ “My way or the highway” folks

# WHO RUNS IT?

What kind of people should be on the start-up board?

Look for:

- ◉ Entrepreneurial skills, visionaries, “idea people”
- ◉ Analytical & math skills, financial, bookkeeping, Excel
- ◉ Time management, project management, organizational, planning skills
- ◉ Persuasion, fundraising, sales, “people skills”
- ◉ Supervisory, personnel/human resource management
- ◉ Verbal, writing, communication
- ◉ Technical, computers, email, word processing, spreadsheets, social media
- ◉ Subject matter expertise
- ◉ Service recipients



# Process Steps

## HOW TO START A NONPROFIT

# START-UP STEPS

## Step 1: What kind of organization?

1. To incorporate or not to incorporate?
  - a. Incorporation offers some liability protection;
  - b. Entity separate from its members;
  - c. Continuity of existence.
2. Incorporation is matter of state law
  1. Filed with the state;
  2. Subject to state corporate law.
  3. Bylaws required to complete formation.
3. After incorporation, can get EIN and open bank account.

# START-UP STEPS

Incorporation requires:

- ◉ Name
- ◉ Purpose statement
- ◉ Members or no members?
- ◉ Required IRS language
- ◉ Location of principal office
- ◉ Officers (President, Treasurer & Secretary) & Directors names with residential addresses

For effective incorporation, must also have bylaws.

# START-UP STEPS

## Step 2: Charity Registration

1. Organizations planning to solicit the public must register with Attorney General.
  - a. “Solicitation” is broadly defined—includes “asking for money”, as well as selling tickets to events & grant-seeking.
  - b. Certificate of Solicitation
2. MA Attorney General has oversight of charitable giving & charities.
3. Initial registration forms depend on whether organization is still in first fiscal year at time of registration.
4. Organizations that are not charities are not required to register unless they will fundraise.

# START-UP STEPS

## Step 3: Tax-exempt Status

Is **fiscal sponsorship** an option?

1. Best for certain organizations:
  - a. Those wanting to “test the waters”;
  - b. Those with expected short life spans;
  - c. Those needing to “hit the ground running” and immediately start delivering services.
2. Contractual relationship with sponsor.
3. Sponsor usually charges fee.
4. Sponsor retains discretion & control over funds donated to it for sponsored organization.
  - a. State (AGO) has interest to ensure gifts are transferred to sponsored organization.
5. Gifts to sponsor for sponsored organization are tax-deductible.

# START-UP STEPS

## Getting tax-exempt status:

1. Apply to IRS for tax-exempt status; two forms: 1023 or 1023-EZ.
2. 1023-EZ may be used if income is projected to be less than \$50K in each of next three years; other eligibility requirements.
  - a. IRS conducting random follow-up.
  - b. Quicker response from IRS
  - c. \$400 fee.
3. Full 1023 is 12+ pages with additional schedules, lots of detail. \$400 or \$850 fee.

# START-UP STEPS

## 1023-EZ

- ⦿ Signed under penalties of perjury;
- ⦿ Requires attesting
  - Organization is organized and operated exclusively for exempt purposes;
  - Only insubstantial unrelated activity;
  - Assets permanently committed to charitable purposes;
  - No private inurement;
  - No political campaign activity;
  - Insubstantial lobbying & influencing legislation;
- ⦿ List of up to 5 board members;
- ⦿ Contact info.

# START-UP STEPS

1023 - full application includes

- ◉ Full details of planned activities;
- ◉ 3-5 years of financial information;
- ◉ Relationships among board members, between board members & corporation;
- ◉ Fundraising plans;
- ◉ Additional schedules for specific types of organizations.
- ◉ \$400 fee only for organizations with expected income less than \$10,000 annually.



# START-UP STEPS

Before deciding which form to use, consider:

- ◉ Full 1023 is “settled”. Resulting tax-exempt status is unlikely to be questioned.
- ◉ 1023-EZ is new; some authorities think it makes tax-exempt status too easy.
- ◉ In response to such concerns, IRS is conducting random follow-ups on 3% of organizations filing 1023-EZ; other follow-up beyond random sample may be possible (e.g., audits!).

# START-UP STEPS

## Step 4:

1. Register with MA DOR for income & sales tax exemption.
2. Can also register with US Post Office for bulk mailing permit.
3. Organizations owning real estate can seek property tax exemption.

# HAPPILY EVER AFTER...

Complete annual filings every year...or else!

1. Annual report to Secretary of State, due Nov. 1;
1. Annual filing with MA Attorney General to obtain Certificate of Solicitation:
  - a. Form PC and fee;
  - b. IRS Form 990-EZ or 990 (even if not filed with IRS).
2. Annual filing with IRS:
  - a. 990-N (electronic) if tax year income < \$50K ; or
  - b. 990-EZ. If tax year income > \$50K but <\$200K; or
  - c. 990 for those not eligible for 990-N or 990-EZ.

# DON'T FORGET TO FILE...

Failure to file annual reports has serious consequences.

- ⦿ Failure to file Annual Reports with Secretary of State for 2 consecutive years can result in revocation of corporate status.
- ⦿ Failure to file information returns with IRS (990/990-EZ/990-N) for 3 consecutive years results in automatic revocation of tax-exempt status.
- ⦿ Failure to file with Attorney General can result in severe financial penalties.

# UPCOMING PROGRAMS

- ◉ **Top 10 Mistakes on 990-EZ**

Wednesday, May 4 at 6:00 pm, \$10/pp

- ◉ **How to Ask for Money: An Experiential Workshop**

Friday, May 13 at 8:30 am at Grace Episcopal Church; with light breakfast. \$25/pp; discount for 2<sup>nd</sup> person from same organization.