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**FREQUENTLY ASKED QUESTIONS (FAQs)
ABOUT
NEW NONPROFIT ORGANIZATIONS**

Many people consider setting up a new nonprofit organization. It is often more complicated than they had hoped. Federal tax laws apply, as do state tax laws, Attorney General rules and other laws. Before going very far, it is necessary to address whether the new organization will be a corporation, a trust or an association. And then you must determine whether it will be a “private foundation.” Or will it qualify for an exemption from private foundation status? Or might it be a “private operating foundation”? And how many applications need to be filed? This bulletin addresses a few frequently asked questions.

Q1 – Do we need a “business plan” for our nonprofit project?

A1 – Yes, you need to have a plan just like you would for a new business venture. You need to define what you want to accomplish and what it will take to get there. You need to research who else is working in this space, just the way for a new business you would identify the competition. What do they have going for them and how do they come up short? Then you need to answer the question “What will I be able to do that no one else in this space has been able to do? Is setting up a new organization the

best way to make my special contribution?”

No one can answer your question “Will this new organization be exempt from income tax” until you answer most of these questions.

Q2 – How do I know if what I have in mind will be the kind of activity that the IRS thinks is tax exempt under 501(c)(3)?

A2 – You can check [the info on the IRS website](#). Ultimately, you will

need to speak to someone with expertise in this area, probably an attorney.

Another way it to file with the IRS [your own application for a tax exemption](#). It probably will be a long time before you get a favorable determination letter, if you ever get one. It might be a frustrating experience. Your application might be assigned to someone at the IRS who can help you along. Or it be assigned to someone who, compared to you, is only slightly less confused about the whole process.

Q3 – To make my organization self-sufficient, I am thinking that my organization will engage in a business and the profits from the business will be used for nonprofit purposes. Can that be a Section 501(c)(3) organization?

A3 – Two issues: (1) To qualify for Section 501(c)(3), the organization must be operated exclusively for charitable purposes. The IRS regulations say: “An organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose.” Operating a for-profit business is rarely a charitable activity. So the organization will probably not pass

the “exclusively” test and cannot get an Section 501(c)(3) exemption. (2) The profits of a Section 501(c)(3) organization from an activity unrelated to the charitable activity of the organization are subject to a tax on “unrelated business income.” The tax rate is the same as the rate for for-profit corporations.

Q4 – Is there any situation in which a Section 501(c)(3) organization can conduct a business?

A4 – Two situations come to mind: (1) When the primary purposes of the business is to train unemployed youths to enter the business. (2) When the business is conducted by a C corporation all of the shares of which are owned by the Section 501(c)(3) organization. The corporation will pay tax on its income. The cash flow available after paying taxes can be distributed to the parent organization as a dividend. The tax-exempt parent will not pay tax on these dividends. Note that with the corporate subsidiary, the parent organization is not engaging in the for-profit business (the subsidiary is doing that), so the parent can meet the “exclusively” test for Section 501(c)(3).

Q5 – Do we need to use a nonprofit corporation? Is an association more simple? When would we ever want to use a trust?

A5 – A trust might make sense when the creators of the organization want to specify who will run the organization when they no longer can. Trusts are sometimes used for grant-making private foundations, but rarely for other types of organization. (Fun fact: Stanford University is operated by a trust.)

Setting up an association requires a filing with the Secretary of State and creating detailed bylaws. The bylaws should address most of the issues that the California Nonprofit Public Benefit Corporation already addresses. It is about the same hassle to set up an association as to set up a nonprofit public benefit corporation. The corporation gives the managers more certainty about their duties and liabilities. For this reason, corporations are used often and associations are rarely used for Section 501(c)(3) organizations.

The California Nonprofit Public Benefit Corporation Law was thoroughly reconsidered and revised 1978. It is not perfect, but its terms are well known among nonprofit

attorneys. It provides a reasonable structure for a nonprofit organization. If you are based in California, your questions should be “Is there any reason why I should not use a California nonprofit public benefit corporation for my new nonprofit organization?”

Q6 – We are considering a new family foundation. Our son Jim has been very successful in the family business and is well compensated for his efforts there. Our son Bob has no aptitude for business and we wish his social skills were better. Both Jim and Bob are married and have children of similar ages. Can we make Bob the executive director of our new foundation and have the foundation pay Bob a salary? We know it can't be the same as what Jim gets from the business.

A6 – If you use a California nonprofit public benefit corporation, not more than 49% of the directors can be compensated by the corporation or related to someone who is compensated. If you both are directors, then if Bob is compensated, 100% of the directors are related to someone who is compensated by the corporation. The California Attorney General asked for this law and enforces it. So you must either not compensate

Bob from the nonprofit corporation or not use a California corporation.

It is possible to use a Delaware nonstock corporation for this purpose, and you can get federal and California tax exemptions. Bob's compensation can be no more than a reasonable amount for the services that he actually renders to the foundation.

But there will be pressure to have the foundation compensate Bob in a way that allows him to have a lifestyle similar to Jim's. Succumbing to the pressure could trigger penalty taxes, terrible publicity for the family and trouble with the Attorney General.

The best way to view a family foundation is that cash goes into the foundation from the family, and it never comes back from the foundation to the family. Consult a sophisticated estate planner to find other techniques to fund Bob's lifestyle.

Q7 – Is there any special language that needs to be in the articles of incorporation?

A7 – Yes, lots. The description of the purpose of the new corporation should use the language that the IRS uses to describe this type of purpose

when it satisfies Section 501(c)(3). Failing to check this can lead to delay in getting an exemption, or even rejection of the application for exemption.

The articles must have statements required by the California Nonprofit Public Benefit Corporation Law, by the IRS and by the Franchise Tax Board. If the organization seeks exemptions from property tax or sales tax, other provisions are needed.

It is not unusual to see the articles of incorporation amended when the person who prepared them is not familiar with nonprofit organizations.

Q8 – What filings do we need to make to start a nonprofit organization as a corporation in California?

A8 – The articles of incorporation are filed with the Secretary of State. After the directors elect officers and designate a principal office and a mailing address for the corporation, a "Statement of Information" is filed with the Secretary of State.

An application for an Employer Identification Number is filed after the incorporation.

When the new EIN is obtained, an application for exemption is filed with the IRS. In the application the organization asks for a “favorable determination” by the IRS that the organization is described in Section 501(c)(3) of the Internal Revenue Code. The IRS “determination letter” also states whether the new organization appears to be a private foundation or not and, if not, why not.

The new organization must register with the Registry of Charitable Trusts in the office of the California Attorney General.

When a favorable determination letter has been received from the IRS, the organization must file that letter with the Franchise Tax Board. The FTB then sends its letter recognizing that the organization is exempt from California corporate tax.

Annual “information returns” are filed with the IRS and the FTB. An annual statement is filed with the Attorney General. There are penalties for failure to file.

Q9 – What is the process if we use a nonprofit corporation?

A9 – After the articles of incorporation are filed with the Secretary of State, the person who signed them elects the initial directors and, generally, adopts the bylaws.

The bylaws state whether the corporation will have voting members and set the qualifications, if any, for the directors.

The directors elect officers, set the principal office and, sometimes, stagger their initial terms so that an approximately equal number of board seats will be voted on each year.

The IRS asks in the exemption application if the corporation has a “conflicts of interest” policy, so many nonprofit organizations adopt the policy at this stage. Some also adopt a “whistleblower” policy and a “document retention and destruction” policy, because the IRS asks about these in the annual information return.

If the President or Chief Financial Officer are compensated, or if any directors are also compensated as officers, the Board will generally appoint a “compensation committee” consisting of Board members who

are not compensated or related to anyone who is compensated.

Q10 – We have a low degree of certainty about the amount of the new organization’s receipts for the first few years. So for our exemption application to the IRS, we can use either the short IRS Form 1023-EZ or the long Form 1023? Shorter is better, right?

A10 – You should use the short Form 1023-EZ *only* if you have a high degree of certainty about each answer. Frankly, it is hard to imagine how you would have that degree of certainty unless you have the advice of an attorney who works regularly with nonprofit organizations.

Form 1023-EZ asks the applicant to make statements that are really legal conclusions. It might as well say “Do you qualify as a Section 501(c)(3) organization? Yes or No? If so, are you a private foundation? Yes or No?”

When the IRS started offering Form 1023-EZ, the announced intent was to have fewer IRS people reviewing exemption applications and more people in the field conducting audits. It’s not clear that audits have increased much, including for Form 1023-EZ filers.

An audit of a lightly-advised Form 1023-EZ filer could be bad news for the founders. If the Attorney General got involved, there is a risk of a settlement that includes a promise to never serve as an officer or director of a California nonprofit organization. These settlements are made public, and can ruin reputations.

In my view, a Form 1023-EZ should not be filed unless a long Form 1023 has been completed and any issues raised by it have been analyzed by a nonprofit attorney and discussed with the founders. Once the long Form 1023 has been prepared, it might as well be submitted to the IRS for filing, to obtain certainty about how the IRS reacts to the proposed activities.

Q11 – Can I do it all myself? I bought a book about how to form a nonprofit corporation.

A11 – It will be enlightening to try. But you will probably need professional help to complete the process.

Attorneys who have been to law school, even those with expertise in corporate matters or tax law, seldom get all the documents right on their first few tries. It is not likely that someone without that

technical background will get it right the first time. As with cars, plumbing and computers, it is more expensive for a professional to clean up after a botched DIY job than to do it right the first time. (In the case of a tax exemption application, “doing it right the first time” means creating documents for the new organization from tried and true templates.)

Those who are committed to the do-it-yourself approach often flounder when they get to the questions about “private foundation” status.

Q12 – What is a “private foundation”?

A12 – A private foundation is a Section 501(c)(3) organization that is supported by one family or company. It generally holds funds as an endowment and uses the income from its invested funds to support Section 501(c)(3) organizations that are not private foundations. Federal tax laws require private foundations to distribute at least 5% of the value of their assets each year. Federal tax laws also impose penalty taxes if a private foundation engages in “prohibited transactions.” A tax applies to the net investment income of a private foundation. Less

generous limits on income tax deductions apply to donations to private foundations.

For these reasons, if your organization can qualify for an exemption from “private foundation” status, it generally is worth using the exemption.

Q13 – I am pretty sure that my new organization would be tax exempt under Section 501(c)(3). Would it be a “private foundation”?

A13 – Unfortunately, this is not a simple question. Every Section 501(c)(3) organization is a private foundation unless it qualifies for a specific exemption from private foundation status. Many do qualify. One exemption is for an organization that gets more than one-third of its support from the public. Another is for an organization that generally supports itself with income (such as membership fees) earned from performing its exempt function. [There are many more exemptions.](#) Each exemption has its own body of law.

Q14 – My new organization is going to be privately supported, but it is going to engage in hands-

on charitable activities. It is not just going to send money to other charities. Will my new organization be a “private foundation”?

A14 – It will probably be a private foundation because of the limited sources of support. But because it will be active, it will probably be a “private *operating* foundation.” To a donor, a private operating foundation looks just like a publicly-supported charity (that would not be a private foundation). However, from “inside” the managers see an organization that is subject to all of the restrictions and penalty taxes that apply to private foundations. So a private operating foundation is a hybrid of both.

Generally, references to “private foundations” include private operating foundations, unless the context indicates otherwise. You will sometimes see private foundations that are not private operating foundations referred to as “private *non-operating* foundations,” but this is rare.

Q15 – How much does it cost to have an attorney who knows about nonprofit organizations prepare my documents?

A15 – The whole process can take 25 hours or more for an experienced attorney and legal assistant. At a blended rate of \$400, that would be at least \$10,000. In addition there will be expenses of approximately \$1,400, including filing fees with the IRS, the Secretary of State and the FTB, as well as fees for an attorney service to file documents, fix filing problems, and return foiled documents quickly.

Q16 – Why is it so expensive?

A16 – Because it is a complicated area of the law. Routine nonprofit corporation law is more complex and specialized than routine for-profit corporation law. The tax rules for tax exemptions, private foundation status, unrelated business income and charitable contributions by individuals and corporations are complex and specialized. The laws for the role of the Attorney General and the laws for managing endowments overlap the other laws. State income tax laws are similar but not identical to federal income tax laws. States has unique laws for property tax and sales tax exemptions, for the requirements to solicit contributions locally.

Q17 – Are there alternatives to setting up a new nonprofit organization for my project?

A17 – Yes, and you should consider them. One is to have an organization like [Public Counsel](#) in Los Angeles set up your new nonprofit organization for free as a *pro bono* legal project.

Another is to find an “incubator” or “fiscal sponsor” like [Community Partners](#) in Los Angeles to “house” your project until it is ready to become its own nonprofit organization. The sponsor is a tax-exempt organization whose function is to foster the growth of other organizations. You can use its tax exempt status until you are ready to get an exemption for your own organization. The sponsors are very selective about the projects that they accept, so your “business plan” is very important to them.

You might also find an existing tax-exempt organization with a mission similar to yours. You might be able to conduct your program as part of their organization, using their tax exemption. This is a less formal relationship than an “incubator” or a “fiscal sponsor,” but the end result is the same – you can get started without setting up your own new organization and getting a tax exemption for it.

Finally, you might find an organization that has a mission similar to yours and a tax exemption, but the managers are done with their organization. They might be willing to [hand it off to you](#). It will not be easy to find this organization, and you certainly will want to “kick the tires” a bit before you jump in.

Q18 – My project involves sending money to other countries to be used there for charitable purposes. Anything I should know?

A18 – Lots. Here is [a nice summary](#). Much depends on whether or not the organization is a private foundation. Either way, you need to be intimately aware of the laws designed to restrict funding of terrorist organizations. You do not want the FBI at your door because you ignored these laws.

Q19 – So far, we’ve been talking about federal tax issues. What other laws are involved?

A19 – There are corresponding (but not identical) state income tax laws. There also might be state exemptions from property tax and sales tax, each with its own

requirements. There are state laws governing the Attorney General's role with nonprofits, including raffles, poker nights and casino nights. There is a separate law for managing endowments. There is a federal limitation on the liability of volunteer directors and officers. There are special postage rates for nonprofits and local laws about soliciting charitable contributions.

Q20 – What is the role of the California Attorney General in my new nonprofit organization?

A20 – The Secretary of State will forward to the Attorney General the articles of incorporation of a new nonprofit public benefit corporation. It is the duty of the corporation to register with the Attorney General.

A nonprofit formed under California law or active in California must file annual reports with the Attorney General.

The Attorney General's role with nonprofit organizations is similar to the role that shareholders fill with for-profit corporations. The Attorney General can review decisions of the Board of Directors to assure that they comply with California law. The Attorney General can go to court to remove the directors or officers and to

appoint new ones. The Attorney General can ask a court to transfer the assets of a non-compliant nonprofit to a compliant organization with similar purposes. When the board of directors of a nonprofit corporation plans to dissolve or to transfer substantially all of its assets, it needs the prior approval of the Attorney General, even if there are no assets left to distribute. The Attorney General can follow up on whistleblower reports or new reports about a possibly non-compliant organization. The Attorney General can enter into settlement agreements with officers or directors that will prevent them from serving as officers or directors in any nonprofit organization in California in the future, and can publish these settlement agreements on its website, even if the person being investigated does not admit any guilt. A letter from the Attorney General is a serious matter.

Q21 – My new nonprofit will be exempt from tax, so it won't need to file any tax returns, right?

A21 – A nonprofit must file annually with the Attorney General and every other year with the Secretary of State. A tax-exempt nonprofit in California must file an annual information return with the

IRS and another return with the FTB.

Q22 – The tax returns for my nonprofit organization will be private, just like my own tax returns and the tax returns for my business entities, right?

A22 – No. The exemption application and tax returns of a nonprofit must be made available to anyone who asks to see them. The federal information returns of a tax-exempt nonprofit are sent by the IRS to GuideStar.org, which publishes them on [its website](#).

The articles of incorporation and the statements of information are made available on the [website](#) of the Secretary of State.

All filings and correspondence with the Attorney General are posted on the Attorney General's [website](#).

Q23 – I know that if I want to raise money from investors for my business, I need to comply with federal and state securities laws. If I want to solicit donations to my nonprofit organization, do I have to worry about anything like that?

A23 – Yes. Each state and many local governments require anyone who solicits in their jurisdiction to register first. This is a [difficult issue](#) for national and online programs.

Q24 – I applied to a foundation for a grant to fund my nonprofit project. They told me that they would give the grant to my Section 501(c)(3) organization, if I formed one and got a tax exemption for it. But they would not make the grant to me. Why?

A24 – If a grant-making foundation makes a grant to a U.S. Section 501(c)(3) organization, it's done. It does not have to follow up to see if the money was used properly. It has the right to follow up, if set forth in the grant documents. But it is not required by tax laws to do so.

If that same foundation made a grant to an individual or to a business entity or a foreign nonprofit, it would be required by tax laws to exercise "expenditure responsibility" over the grant, and to report to the IRS each year on the use of that grant. It sounds complicated and it is. So grant-makers avoid it by adopting a policy of not making any grant that would require expenditure responsibility

unless of the board of directors specifically approves it.

Q25 – I happen to know several famous people. I plan to get nonprofit organizations to hire me to put on dinners which these famous people will attend. We will sell tickets to the events, and I will get a cut of the receipts. To be sure I get the right amount, I will collect the receipts, take out my cut and give the balance to the charity. I don't need a license to do this, do I?

A25 – You will need to register with the California Attorney General's office and make reports to it. Expect a lot of [scrutiny and hostility](#). You need a written contract with the charity. Without a written contract, the charity can rescind the deal at any time.

Q26 – We just had a brilliant marketing idea. We will advertise that we will give 5% of our profits to charities. We plan to do a survey to see which charities are the most popular with our target demographic, then we will promise in our ads to donate the money to them.

A26 – Because you will hold the charitable funds, you will be a

“commercial fundraiser.” You will be required to register and file reports with the Attorney General. If you advertise in states other than California, you might have similar obligations in those states.

Q27 – To raise funds for our charity, we are going to have a raffle. Or maybe a casino or poker night. Anything we should know?

A27 – It is a crime to conduct a raffle except with the [permission of the Attorney General](#). Same with a poker night or casino night – [register and follow the Attorney General's rules](#).

Q27 – Our neighbors' child died suddenly. We all wish that we could do something to express our sympathy to the parents. We thought we should all contribute to a memorial fund. This is a common situation, so this must be easy to set up, right? Of course, the people who make big contributions to the fund will want to be assured that they will get a tax deduction.

A27 – Unfortunately, there will not be time to set up a new nonprofit- organization and to obtain a tax exemption for it.

Ideally the family would identify one charity and ask that charity to designate a memorial fund for the child. The donations would go to that charity and, unless the amount is over \$50,000, would probably be used for the operations of the charity. (Or, if the total donations exceeds \$50,000, including pledged funds, the charity might be willing to set up an endowment fund in the name of the child. The \$50,000 amount is arbitrary; each charity sets its own policy for creating endowments.) The family can ask that the acknowledgment letters from the charity refer to the child's memorial fund. That's the easiest way.

It is also possible to arrange with the pastor to receive the funds as donations to the church, with the understanding that the family will name a charity and most, but not all, of the funds will be sent by the pastor to that charity. A friend of the family can collect the checks, total them, and deliver them to the pastor.

Q28 – Well, that's not what we did. We set up a new Section 501(c)(3) organization with the funds that we collected. The parents and a neighbor manage the organization. They still ask for contributions. But everyone

other than the parents has moved on. Sure, it's still sad. But just because we contributed to the memorial fund when the child died, we did not commit to keep making contributions forever. The neighbor is ready to resign as a manager, and encouraged the parents to give up the organization. But the parents feel that giving up the organization will be like saying publicly that they don't honor the memory of their child anymore, and they most certainly do. Now what?

A28 – Somebody needs to tell the parents that letting go of the organization is not letting go of the memory of their child. That the community will not interpret it this way. They should identify an appropriate charity to receive the funds, and start the process of [dissolving the organization.](#)

Q28 – One of our employees left our nonprofit organization to join a competitor. We are concerned that she will use our trade secrets in a way that harms our organization. We are constantly competing with that organization for funds from grant-making organizations. What should we do?

A28 – It is possible that there might be legal remedies available to protect the trade secrets of your organization. Before you pursue them, consider that your organization and your “competitor” are trying to meet the same need. Do your each fulfill your purpose best by acting separately? Or are there areas in which you would more effectively achieve your organizations’ purposes by working together? In fact, does it make sense to have two different organizations in the same community addressing the issues separately, or would both organizations be more effective if combined.

Note that it is possible that if two organizations receive annual grants from a grant maker of \$100,000 each, the combined organization might not receive grants of \$200,000 per year, and in fact might receive only \$100,000 per year, if that is the maximum amount that the policies of the grant maker allows it to make.

It is possible for the two organizations to “date” before getting “married.” It is also possible to combine in [a tentative way](#) that will allow the organizations to separate if the combination does not work.

Q29 – The founder of our organization was undercompensated for many years when the organization was struggling to survive. Now the organization is well funded and has substantial assets. Our founder would like to retire and our Board would like the organization to buy an annuity for him. We recognize that this is not an everyday transaction for our organization. Anything we need to know?

A29 – Yes. The good news is that the IRS regulations allow the Board to take into account the fact that the founder was undercompensated in prior years when you set his current compensation.

The bad news is that the California Attorney General considers it a diversion of the charity’s funds from the charity’s exempt purpose, unless there was a contract with the founder in the early years to pay deferred compensation. The Attorney General has successfully asserted this position in court. So the purchase of the annuity is not going to work if the benefit to the founder in the current year exceeds the value of his services to the organization in the current year.

Consider having a friendly large company hire the founder as a community relations person at a modest salary, and possibly informally reducing its annual commitment to support the organization by a similar amount.

I regularly discuss possible new nonprofit-organizations, organize them and obtain tax exemptions, reorganize them and create related entities, and dissolve them. We also get involved in thorny issues like compensating founders.

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