

10 Fundamentals of Forming a Charitable Organization



Introduction



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Introduction

The enthusiasm and vision to help others spawns tens of thousands of new applications for tax-exempt status each year. The Internal Revenue Service (IRS) approves about three out of every four applications.

Understanding the nonprofit terminology is a good starting point. A nonprofit organization can make a profit. In fact, a nonprofit organization ideally would have at least a nominal profit as it will use profits to continue its mission. Nonprofits do differ, however, from for-profit organizations that distribute profits to the owners.

In order for an organization to be classified as a nonprofit entity, its purpose must be *primarily* related to qualified charitable or educational endeavors. The essence of a nonprofit is to carry on an activity because it is important, and not as a means of generating profits for investors (as with a for-profit organization). This does not mean that a nonprofit organization cannot hire people and pay them for their work, or that it must operate at a loss. Any surplus gained should generate more “good works.”

There are different categories of nonprofit organizations with different treatment, privileges and obligations under the Internal Revenue Code (Code). To qualify for a Federal tax exemption, your organization must be organized for one or more of the purposes specifically designated in the Code. A few major distinctions are outlined below:

The most common type of nonprofit organizations are classified as 501(c)(3) organizations under the Code. They must prove that they operate exclusively for religious, educational, scientific, literary, charitable, public safety, amateur athletic, animal-protection, or child-protection exempt purposes. Churches are included in this category. A 501(c)(3) does not have to pay income taxes and is authorized to issue tax-deductible receipts to donors for contributions. Having tax-deductible status significantly helps in attracting grants and contributions from foundations and individuals that are crucial to a charitable organization.

Other types of nonprofit (tax-exempt) organizations include: lobbying organizations, fraternities, and various other associations. While they do not have to pay income taxes, they are not able to issue tax-deductible receipts to donors. Therefore, donors to these organizations cannot take deductions on their income taxes. Additionally, these other categories have different constraints and obligations under the Code.

Here are 10 fundamental issues to consider before you dip your toe in the nonprofit tax-exempt application waters. From time to time, this document will refer to relevant ECFA standards.

Develop and convey the
organization's vision



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Develop and convey the organization's vision

One of the most fundamental places to begin the formation process is to solidify what the vision is for the organization and how to best convey the vision. This step is crucial in the success of an organization because the founder's role will be one of gathering others around the vision and rallying them to implement it whether it is through contributions, volunteering, or going out into the mission field.

Mission drift can occur for various reasons—often from a lack of focused direction which can then spiral into an organization's demise. It is therefore important that the organization's vision and mission are firmly grounded before the organization is launched. This is not to say that a mission statement is to be a constraint to growth, but rather that a well crafted vision will inspire growth and keep that growth focused.

Find the right advisors



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Find the right advisors

First and foremost, seek advice. Find one or more wise counselors. It's biblical—in multitude of counselors, there is safety (Prov. 24:6).

As noted nonprofit attorney Bruce Hopkins says “the label nonprofit does not mean ‘no planning.’” An experienced advisor can be a great resource to the founder in formation and operational issues. A review of significant issues by a professional is often desirable to navigate the statutory, tax, and accounting rules pertaining to nonprofit organizations.

It may only take one individual to incorporate in your state. But, it usually takes more than a few people to get most nonprofits up and running. When considering placing an organization under the umbrella of an existing organization (see fiscal sponsorship), be careful as there are traps for the unwary in using this approach.

Determine the style of
governance and board size



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Determine the style of governance and board size

The style of governance chosen will determine how the bylaws are written. First of all, should an organization require its board members to be independent? ECFA's Standard 2 requires board independence, and the IRS through its annual filing requirements (Form 990) now inquires about board independence. While there are some variations, the two basic governance styles are:

- **Membership style.** The membership style is appropriate for certain nonprofits. In the most typical membership governance style, members have the authority to elect board members and change the bylaws.

While the membership style provides representation broader than a nonprofit board, there are challenges that accompany this style of governance. It can be awkward to manage competing interest of members and the nonprofit board. It can also be difficult to persuade a large membership group to make fundamental changes in governing documents.

- **Self-perpetuating style.** The self-perpetuating board style is most commonly utilized for nonprofits. In this style, the board generally has the power to elect board members and change governing documents.

Board size is an important issue. Most bylaws give the organization flexibility in determining board size, e.g., "The board shall be comprised of between three and nine board members." If this approach is followed, a nonprofit may start with a smaller board and increase board size as the organization grows. The average board size for nonprofits is about 15. (Bylaws that specify an exact number of board members, e.g., "there shall be seven board members," establish a very inflexible restriction and this should be avoided unless state law requires this approach.)

Determining whether the board is numerically and functionally independent is also an important decision. ECFA requires an independent board—a board that is primarily comprised of non-staff members and non-relatives. There is also a significant interest in independent board governance by the Internal Revenue Service. The Form 990 requires the disclosure of whether a board is independent.

Prepare nonprofit organizing documents



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Prepare nonprofit organizing documents

After deciding which state in which the organization will be formed, developing organizing documents is a fundamental next step in the tax-exempt application process. While incorporation is usually desirable, it generally is not mandatory. To apply for tax-exempt status, an organization must submit a conformed copy (a copy that agrees with the original document and all amendments to it) of its Articles of Incorporation (and the Certificate of Incorporation, if available), Articles of Association, Trust Indenture, Constitution, or other enabling document. If the organization does not have an organizing document, it will not qualify for exempt status. Bylaws alone are not organizing documents. However, if the organization has adopted bylaws, include a current copy with the application. It is a good idea to keep these documents in a corporate records book.

Religious discrimination in hiring is allowed for churches and religious organizations (or parachurch nonprofits) according Title VII of Civil Rights Act of 1964. The Supreme Court unanimously affirmed this principle in the 2012 case *Hosanna-Tabor v. EEOC*.

Obtain the employer identification
number (EIN)



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Obtain the employer identification number (EIN)

A nonprofit must have an employer identification number (sometimes referred to as a taxpayer identification number). The IRS assigns this number after you properly complete and file Form SS-4. When the organizing documents are complete it is a good time to file Form SS-4.

There is often confusion about when a nonprofit organization has a tax-exempt number. The employer identification number is not a tax-exempt number. The identification number has nothing to do with tax-exempt status.

Prepare the Form 1023,
if applicable



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Prepare the Form 1023, if applicable

If you apply to the IRS for a ruling or determination regarding your tax-exempt status, you are not asking the IRS to grant tax-exempt status. You are asking them to recognize a tax-exemption that already exists (assuming your organization qualifies).

- Completing and filing Form 1023, Application for Recognition of Exemption, is generally required within 27 months of becoming an organization for organizations desiring to be tax-exempt other than churches, integrated auxiliaries of churches and conventions or associations.
- A user fee, which is adjusted from time to time, must be submitted with the application. Form 1023 is not used to apply for a group exemption, e.g., a central organization with subordinate organizations.

- The Form 1023 should be carefully prepared just as you would a legal document. This form will be subject to review throughout the organization's existence. The organization will be required to provide a copy of the application, and related correspondence to anyone who requests it under the federal public disclosure rules.
- After Form 1023 is filed, the application process may take several months, including responses to the IRS concerning additional information that is requested. If the application is not complete, the IRS may return it and ask the group to file again. A practical tip here is to have the Form 1023 prepared by a professional who has experience with the form. If there are repeated inquiries or requests for reapplication the process can drag on for a significantly longer time.

(IRS Publication 557, Tax-Exempt Status for Your Organization, available at [IRS.gov](https://www.irs.gov), may be very helpful in completing Form 1023.)

Structure the organization
to avoid private inurement
and private benefit



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Structure the organization to avoid private inurement and private benefit

The basic private inurement principle is to ensure that a nonprofit organization is serving public interests, not private interests. A nonprofit organization must not be organized or operated for the benefit of private interests (the creator of the nonprofit organization, his or her family, persons controlled by private interests, or any persons having a personal and private interest in the activities of the nonprofit.)

The *private benefit* concept is broader than private inurement and it can operate without the involvement of an insider. This concept may apply even when the beneficiary is a for-profit corporation.

Address charitable contribution issues



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Address charitable contribution issues

The founder(s) must determine if charitable funds can be raised to get started. Foundations and corporations generally do not fund start-up nonprofits. Those first contribution dollars usually come from friends and associates, who share in the vision and mission of the new nonprofit.

When a new charity is in the process of being formed, it is common for donors to make gifts to the charity and to desire a receipt that may be used for tax deduction purposes. The question often arises whether and when the new charity can legitimately issue charitable receipts.

The earliest date that a charity may appropriately issue donation receipts is the date on which the charitable entity is legally formed, e.g., usually the date the incorporation is approved by the state. The importance of the legal formation is emphasized in the instructions for Form 1023, which states that if Form 1023 is filed within 27 months after the end of the month

in which an organization is legally formed, and the IRS approves the application for tax-exempt status, the effective date of the tax-exempt status is retroactive to the legal date of formation. Therefore, it appears that only gifts received on or after the date of incorporation could be appropriately receipted for charitable donation purposes.

For many charities, obtaining tax-exempt status is a relatively routine process. Therefore, it is typical for them to begin to issue receipts as soon as they are incorporated with a high degree of certainty that they will be approved for tax-exempt status. However, some large donors and many foundations require an exemption determination letter. Therefore, a charity whose tax-exempt status has not been approved should alert these particular donors that they do not yet have an exemption determination letter.

(See ECFA Standard 7, which relates to issues associated with charitable contributions.)

Address administrative issues



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Address administrative issues

The following administrative issues are very important:

- **Determine your accounting system and related controls.**

Many nonprofits start with a very simple accounting system. (See ECFA Standard 3.) If a significant number of donations will be received, it is also important to use an electronic donor management system (see below).

It is vital to establish sound accounting and internal control systems. Procedures or internal controls are generally the most cost effective means to avoid fraud, lawsuits and self-dealing. (See ECFA Standard 4.) Furthermore, these will allow the organization to smoothly transition as its personnel expands. Here are a few basic concepts:

- **Cash and other revenues.** When one individual has control over an entire accounting transaction, fraud is possible. To prevent most types of theft, segregate employee duties. At minimum, the following duties should be segregated to prevent theft: collecting cash, preparing bank deposits, reconciling bank statements, and posting receipts to the general ledger/contribution system.

- **Expenditures.** At a minimum the following duties should be segregated: approval of expenditures, writing checks and signing checks.

- **Donor management systems.** A donor management system will assist the nonprofit in building and using its donor database. Such systems enable the tracking of contributions and receipting. It is also important to track restrictions associated contributions as a failure to use the funds as instructed could irritate donors and violate state law.

- **Policies.** It will be important as the nonprofit expands to ensure there are sufficient policies so as to have uniform momentum between employees and the organization as a whole. While these may not be a priority at formation, they should be considered during these initial steps and adopted as applicable. In addition, organizations will be faced with specific questions about policies on the Form 990. The following policies are relevant:

- **Ensuring biblical financial and other operations.** “Devise methods to confirm that the financial and other operations of the ministry are conducted in a manner which reflects generally accepted biblical truths and practices.”

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- **Board independence.** One important policy is to ensure that members of the board of directors are those, who will make decisions in the best interests of the organization, as opposed to decisions benefitting their personal interests. (See Board Independence.)
 - **Review of Form 990.** Organizations must describe in Form 990's Schedule O the process, if any, the organization uses to review the 990. While no process to review the Form 990 is required, consider enacting a simple 990-review policy describing how the board approves the 990 before filing.
 - **Conflict of interest policy.** Organizations are asked on the 990 if they have a written conflict of interest policy. Consider having all board members to agree to a policy that they will take proper precautions should a conflict of interest arise. (See ECFA Standard 6.)
 - **Whistleblower policy.** Putting in place procedures, where a whistleblower can confidentially report improper activity is advised. A nonprofit should communicate the procedures to employees in a written policy.
 - **Document retention and destruction policy.** An organization's document retention policies should ensure

that necessary records and documents are adequately protected and maintained, as well as ensure that records that are no longer needed or are of no value are discarded at the proper time.

- **Compensation approval of top management official and key employees.** A major challenge to boards is to carefully establish and document the executive compensation process and then balance fair and reasonable compensation within the budgetary constraints of the organization.
- **Disclosure rules.** Policies regarding federal disclosure rules, e.g., making 990 available, are also necessary. Disclosure of governing documents is not necessarily required.
- **Payment of benefits rules.** It is important to have a policy related to certain benefits paid to employees toward personal services (services for the personal benefit of employee).
- **Gift acceptance guidelines.** It is wise to set up guidelines for deciding when to accept non-cash contributions.

Determine required filings
with federal, state, and local
governments

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Determine required filings with federal, state, and local governments

Your nonprofit organization may be subject to a variety of filing requirements. If you have at least one employee, there are Form 941 and W-2 filings. If you have at least one independent contractor to whom you have paid \$600 or more in a calendar year, you file Forms 1099-MISC and 1096. Most non-church organizations must decide whether to file Form 990, Form 990-EZ, or Form 990N with the IRS. (See ECFA Standard 5.)

Forty-six states have some form of a charitable solicitation act (a statute regulating charitable fundraising). And many county and local municipalities have similar regulations. Annual filings are often required to satisfy these laws.

If your charity has at least \$1,000 or more of gross unrelated business income (UBI), think broadly about which exempt purpose(s) the ministry may want to utilize. This will help prevent the organization from needing to modify their exempt purpose as new related activities arise. Also, consider a sample UBI policy.

Summary



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An organization's inception is an excellent time to adopt fundamental and biblically-based standards. Even if the organization is not yet a member of ECFA, the nonprofit can follow their Standards of Responsible Stewardship and best practices found on ECFA's website (ECFA.org). An excellent stewardship philosophy statement has been jointly developed by ECFA and the [Christian Leadership Alliance](#) (CLA).

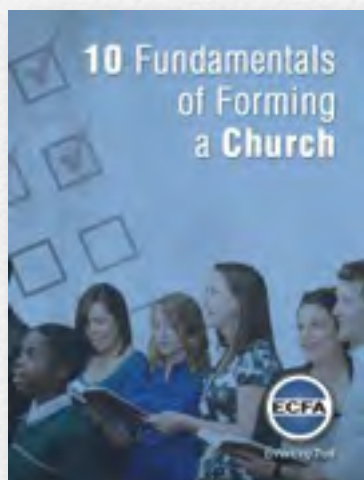
While there are a host of other issues that may be important for you to consider early in the development of your nonprofit (use of the Internet, lobbying, political activities, liability insurance, proper fundraising techniques and much more), this list of 10 fundamentals covers some of the most basic issues.

Resources

- “Financial Information for Nonprofit Managers,” Part I: Compliance (Anderson University & ECFA)
- “Tax-Exempt Status for Your Organization,” which provides information about filling out Form 1023 (IRS Publication 557)
- “Tax on Unrelated Business Income of Exempt Organizations” (IRS Publication 598)



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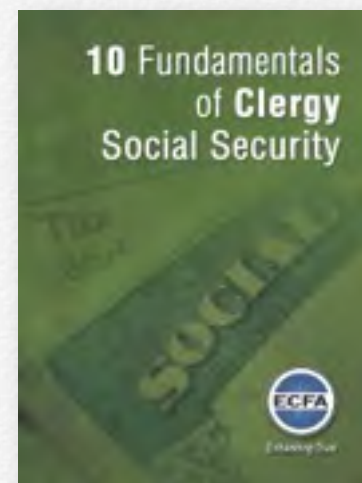
10 Fundamentals of Forming a Church

Churches form to give followers of Christ the opportunity to worship together, grow in faith, and meet the needs of the local community. Although churches are formed for spiritual purposes, there are also practical legal and financial consequences that arise when organizing a church. This book provides an overview of the ten most fundamental issues to consider when starting a new church.



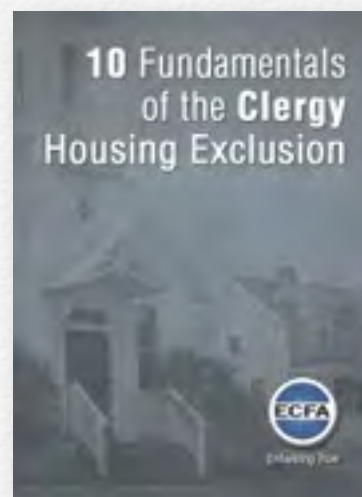
10 Fundamentals of Clergy Tax

This book provides a cogent overview of the ten most basic fundamentals of clergy tax. Clergy who understand these ten fundamentals will have a better understanding of the Federal tax issues impacting them. Some of these crucial issues include the clergy housing allowance, expense reimbursements, social security tax and more.



10 Fundamentals of Clergy Social Security

Clergy social security is one of the most complicated issues for many clergy in the U.S. It all starts with two types of social security—and a minister might be subject to both types of social security in the same tax year. The tax forms do not provide a convenient way to calculate the amount subject to social security tax—and this is just the beginning of the challenges facing clergy. If you understand the ten fundamentals discussed in this book, you will have a good grasp of the social security basics that are often puzzling to ministers.



10 Fundamentals of the Clergy Housing Exclusion

The clergy housing exclusion provides an income tax advantage to nearly every member of the clergy—in some instances ministers can save thousands of dollars per year using this tax provision. Maximizing this benefit requires coordination with the church, keeping good records of housing expenses, and applying the housing exclusion limits provided in the tax law. If you understand the ten fundamentals discussed in this book, you will have a sound understanding of the housing exclusion basics for clergy.

Watch for future books which will be published soon.

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