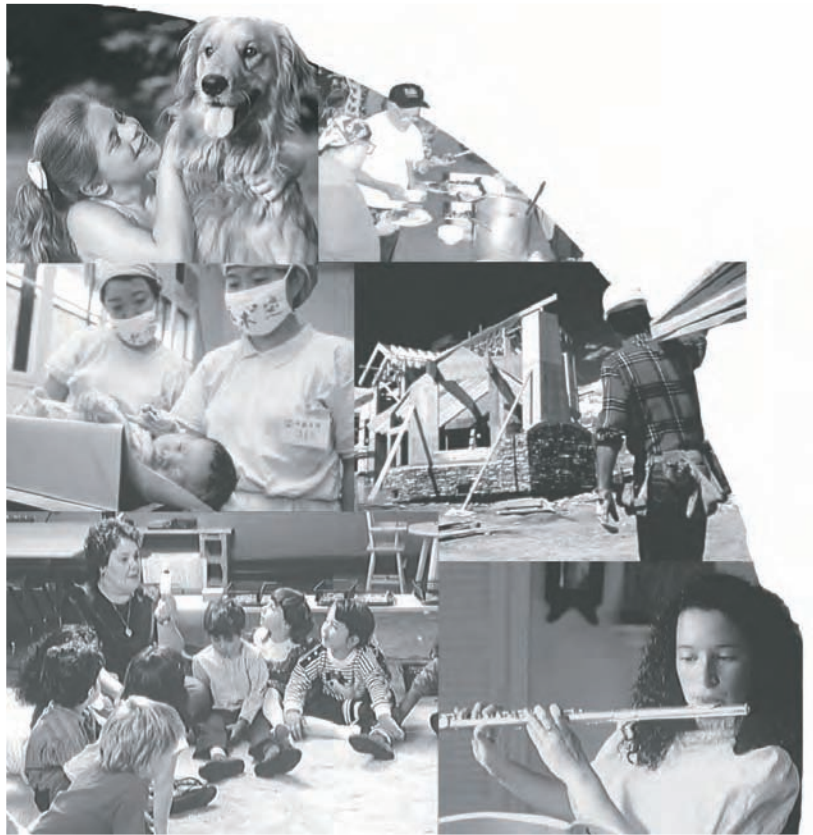


What you need to know  
before starting a nonprofit



# GET READY GET SET



A project of the  
CALIFORNIA MANAGEMENT ASSISTANCE PARTNERSHIP

## GET READY, GET SET

What you need to know before starting a nonprofit

Peter B. Manzo and Alice Espey

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Peter B. Manzo and Alice Espey  
with Nora Burton and Snow Tempest



A project of the California Management Assistance Partnership



Published by the Center for Nonprofit Management

# Preface

This book was written as a project of the California Management Assistance Partnership (C-MAP), an informal collaboration of nonprofit organizations that provide management information, training, and consulting services to nonprofit organizations throughout California.

Along with our C-MAP partners, we were compelled to write this book because we hear from literally thousands of callers each year who ask, “How do I start a nonprofit organization?” This is, in fact, the most frequent question we receive. Many of the people we talk with do not fully understand what is needed to build a successful nonprofit organization and what they must do to comply with the laws and regulations that apply to nonprofit organizations. This understanding is critical to the success of a new organization. We also receive hundreds of questions each year from groups that have started a nonprofit organization but are not sure what to do next. They are struggling to raise funds and attract supporters, and partly as a result, they do not have sufficient time or resources to build the organization. We often encourage them to consider how much more quickly and effectively they might accomplish their goals if they could find another way to put their passion and energy to work on their causes, rather than spend so much effort creating a new nonprofit organization.

This book is not intended as a guide to starting a nonprofit organization. Several other good publications do that, and we will tell you about them when we get to implementation steps. Instead, we address a question that we ask you to consider first: “Is creating a new nonprofit organization the best way to accomplish your objectives?” We want you to successfully reach your goal. Sometimes the best way to do this is to start a nonprofit organization; more often it is not. If, after reading this, you decide that starting a new nonprofit organization is indeed the best course, we want you to be ready for the challenges ahead. (In the latter sections of this booklet, we relent and outline the steps involved in establishing a new nonprofit organization.)

The many individuals who have shared their dreams with us have shaped this publication. Your experience will help us improve it. Please feel free to send your comments to your local C-MAP partner. To locate the partner near you, visit [www.c-map.org](http://www.c-map.org) or our Nonprofit Genie Web site, [www.genie.org](http://www.genie.org). We wish you well in your efforts to improve your community. Please let us know if our work has helped you and how we can improve upon it.

# Acknowledgments

Many thanks to our California Management Assistance Partnership partner organizations and their Information and Referral staff, and particularly to: Linda Brady of the Center for Nonprofit Management for her research and suggestions; Sara Roscoe Wilson, Alice Lowe, and Lee Schneider of Nonprofit Management Solutions in San Diego; Beverly Braun of the Nonprofit Support Center in Santa Barbara; Judy Ross of the Long Beach Nonprofit Partnership; William Staley, Esq., of Arter & Hadden for his insightful legal review; The California Endowment for its generous support; and to all the managers, staff, and volunteers of fledgling or established nonprofit organizations whose questions and comments helped shape this resource.

This book is a successor to an earlier booklet, also titled “Get Ready, Get Set,” published by the Center for Nonprofit Management. That book was written by Patty Oertel and William Ramseyer; we are indebted to them, especially to Patty, who recognized the need for a guide for those seeking information about forming a new nonprofit organization.

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# Preparing Well To Do Good

# 1



## Working for the public good is serious business

**T**he nonprofit sector is larger and more influential than many people realize. Most people would be surprised to learn that in the United States, nonprofit organizations contribute 8% of the Gross Domestic Product, employ 10% of the workforce, and generate approximately \$750 billion in annual revenues. In 1998, California's public charities reported total revenue of more than \$68 billion.

Nonprofit organizations provide medical care, education at the preschool through university levels, museum exhibits and arts performances, health and athletic facilities and programs, child care, workforce training and education, counseling, food and shelter, housing, economic development, and much more.

Funding for charitable endeavors is precious and increasingly scarce, and the needs those dollars serve are crucial to the health and well being of countless individuals and communities. As a result, these charitable funds and the activities they support demand the highest level of stewardship. Further, nonprofit organizations face many of the same challenges that for-profit companies confront (such as controlling quality, managing and motivating personnel, attracting investors/donors), but they typically do so with far fewer resources than their for-profit counterparts. Finally, nonprofit organizations differ substantially from for-profit enterprises in many critical respects, so management solutions and strategies that succeed with for-profit enterprises cannot simply be applied to nonprofit organizations; indeed, nonprofit organizations encounter many unique challenges. It should be clear, then, that starting a nonprofit organization requires just as much planning as launching a for-profit business enterprise, if not more.

Most important, while in some ways nonprofit organizations are very similar to for-profit enterprises, nonprofits face moral and ethical issues that do not come

### What we mean by “nonprofit organization”

Throughout this booklet, we use the term “nonprofit organization” to refer to groups whose purposes are to benefit the public and which are exempt from income tax under Sections 501(c)(3) or 501(c)(4) of the federal Internal Revenue Code. (In actuality, there are more than 20 categories of tax-exempt organizations under Section 501 of the federal tax code, all of which are “nonprofit” organizations, so, while the term “nonprofit” is imprecise, we try to use it in the way most people commonly use it.)

into play with for-profit enterprises. Perhaps the preeminent rule is similar to the Hippocratic oath that doctors take: **First, do no harm.** Nonprofit organizations deal with many of the most sensitive, personal and difficult problems, from child abuse, mental health, or chemical dependency on a human services scale, to important issues such as civil rights or environmental protection. While the nonprofit sector is, and should be, a rich source of innovative approaches to important challenges, it is not simply a space in which to “let a thousand flowers bloom.” Any experimental approaches should be grounded in a careful review of the best known practices. If you go forward without careful consideration, you run a high risk of failure that may poison the well for others trying to address the same issues, not to mention hurting the very people or issues you seek to support.

Nonprofit directors, officers, and managers are also bound by the following simple ethical rule: **You must be faithful to the public good above your personal interests.** This is not only an ethical duty, but also a legal duty that can be enforced under the law.

Accordingly, a nonprofit organization should only be created to serve an important public purpose, and only after careful consideration of (1) whether forming a new organization is the best vehicle for accomplishing that purpose and (2) whether you and your supporters are prepared to form this new organization.



## Key characteristics of nonprofit organizations

**W**e have found that certain characteristics best help individuals clarify whether a nonprofit organization is the appropriate vehicle for their goals. These concern purpose, ownership, control, and accountability. We describe these essential characteristics here so you can consider them before continuing.

### Purpose

The term “nonprofit” does not mean the organization cannot make a profit. In fact, in order to survive nonprofit organizations must have a surplus of revenues over expenses. The term “nonprofit” is used because a nonprofit organization is set up not for the purpose of making a profit, but for pursuing public benefit purposes recognized under federal and state law—for example, an educational, scientific, literary, or charitable purpose.

What makes an organization “nonprofit” is that:

- the mission of the organization is to undertake activities whose goal is not primarily to earn a profit;
- no person owns shares of the corporation or interests in its property; and
- the property and any income of the corporation are not distributed to any “owners,” but instead are recycled into the corporation’s public benefit mission and activities.

If the world seems cold to you,  
kindle fires to warm it.  
- *Lucy Larcom*



## Ownership

A nonprofit organization, in a sense, is “owned” by the public. No private person can claim ownership or control of the organization. The assets of a nonprofit organization are irrevocably dedicated to charitable, educational, literary, scientific, or religious purposes. That means the nonprofit’s cash, equipment, and other property cannot be given to anyone or used for anyone’s private benefit without fair market compensation to the organization. Moreover, a nonprofit’s property is permanently to be used for exempt purposes. When and if the organization decides to dissolve, any assets remaining after the debts and liabilities are paid must go to another nonprofit organization—not to members of the former organization or other private individuals.

## Control

Control of a nonprofit organization is vested in a governing board of directors or trustees. The board’s responsibility is to see that the organization fulfills its purpose. To this end, the board makes final decisions regarding the direction and staffing of the organization. Board members do not act as individuals, but must act as a group. No one should be guaranteed permanent tenure on a board, and the board may decide it is necessary to fire an executive or to remove board members. This means that no one person, not even the founder, can control a nonprofit organization. Board members should be supporters of the organization who donate their time and money to its purpose. Under California law, fewer than half of the members of the board of directors of a public benefit nonprofit can be paid employees or officers, or related to other persons who are paid employees or officers.

## Accountability

The California Attorney General has power to oversee the operations of public benefit corporations and can even step in and take a corporation to court to make sure it complies with the law. Nonprofit organizations are accountable to the public and must file annual information returns with federal and state governments. These returns report the financial operations of nonprofit organizations, including the salaries of the five (5) highest paid non-officer employees. IRS Form 990 Information Returns are public information. Nonprofits must make these returns available to members of the public who request copies, and copies are also available on the Web from the California Attorney General’s Registrar of Charitable Trusts (<http://caag.state.ca.us/charities/>) and private websites (for example, [www.guidestar.org](http://www.guidestar.org)).

<b>Nonprofit &amp; For-Profit Comparison</b>		
	<b>Nonprofit</b>	<b>For-profit</b>
Purpose	Public Benefit	Maximize revenues and value to shareholders
Ownership	Community "stakeholders"	Shareholders
Sources of Revenue	Donations, Grants, Contracts, Borrowed funds Earned revenue from services and products	Purchase of shares by Investors Earned revenues from services and products Borrowed funds
Regulation	Internal Revenue Service State Attorney General	Securities & Exchange Commission Shareholders - Stock Market



## Planning is essential

**P**eople who are passionate about a cause are very eager to get started. If you feel tempted to incorporate an organization and seek tax exemption as your first steps, we ask you to pause first and fully investigate the feasibility of launching and sustaining a new organization.

It is accepted wisdom, especially in the business world, that those who fail to plan, plan to fail. Unfortunately, some people who would never start a for-profit venture without first gaining some experience in the field, crafting a business plan, and hesitating for a long time before asking their family and friends to invest, fail to apply the same logic to starting a nonprofit organization.

As competitive as the for-profit world is, it is even harder in many ways to develop a successful nonprofit organization, and the stakes for our communities are much higher. A failed business affects primarily the owners and investors. In contrast, a failed or marginally successful nonprofit organization wastes scarce charitable resources that could be used to serve those in need. Further, a poorly managed nonprofit organization reflects poorly on the entire nonprofit community and affects the ability of other nonprofit organizations to gather support.

### Is this you? Put your passion into planning

Many people who feel strongly about a cause also feel without sufficient study or planning, that they already know what programs they will need to operate. They realize that they will need resources to accomplish their goals, and that they will need tax-exempt status in order to raise funds from foundations and individuals. Therefore, they conclude that the first thing to do is to form a nonprofit corporation and apply for tax exemption. Unfortunately, this approach puts the cart before the horse. In reality, the organization's chances of receiving tax exemption and then convincing donors to fund its projects will depend on how the group addresses the planning steps described in this section. **Keep in mind that if you are truly passionate about an issue, the best thing you can do is to make sure you do the best possible job in addressing it, and that will take strong planning.**



## Reasons not to start a new nonprofit organization

**B**efore discussing how to decide whether you should form a new nonprofit organization, it may be worthwhile to describe some reasons that should not lead to the formation of a new charitable organization.

**You have a time-limited special project that will benefit your community (e.g., building a swimming pool, sponsoring an art exhibit).**

Though these projects may well have a public benefit purpose, there are more practical and effective ways to accomplish these goals than creating a new organization. Review the section on alternative structures on page 16 if you have this type of goal.

**You wish to support a needy individual (a sick child, a family in distress).**

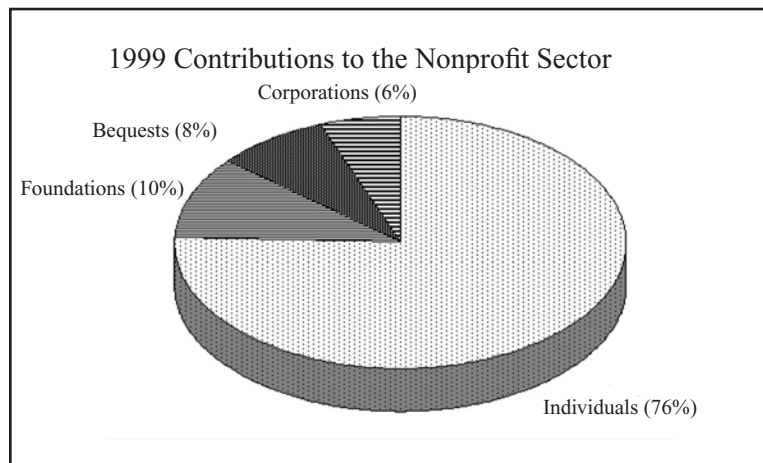
Nonprofit organizations cannot have as their purpose the benefit of specific individuals. Nonprofits that provide human services must do so for an entire class of people. Besides, most people who are motivated to give to help specific people, whether someone they know or someone they learned about on the news, give regardless of whether their gift is tax deductible—or they give to a nonprofit organization that helps people in similar situations. It's fine to “pass the hat” and to explore existing resources in the community.

**You think a lot of grant money will be available.**

Most nonprofits survive with diverse sources of support, of which grants are often a small percentage. Most financial support comes from individuals. Further, grants are not easy to come by. Funders usually look for broad community support and an established track record in organizations they consider funding, and many foundations do not fund on a multi-year basis. The table below shows the reality of grant funding in the nonprofit sector.

We haven't got the money, so we've got to think!

- Ernest Rutherford  
1871-1937 in *Bulletin of the Institute of Physics* (1962)



(1999 Contributions to the Nonprofit Sector: \$190.16 Billion, By Source of Contribution  
Source: Giving USA 2000/ AARFC Trust for Philanthropy)

**You have a service or product you want to provide below cost or donate, but want a tax deduction.**

Business owners, professionals such as dentists or lawyers, and other people with special skills often want to provide their services, or distribute their products below cost or for free, and are interested in getting a tax deduction for their contributions. The simple answer is that generally, though your motives may be altruistic, donating goods or services does not merit forming a new nonprofit organization.

If you want to donate a good or service, you might find it best to volunteer with or contribute to an existing tax-exempt organization, which you do not control. In that case, you may be able to deduct the value (on cost) of goods donated or expenses associated with your services (e.g., cost of

You cannot be a leader, and ask other people to follow you, unless you know how to follow, too.

- Sam Rayburn

materials for pro bono dental work, but not the value of dental fees). The reasons for this are as follows: (1) Donations of goods are only deductible as charitable contributions if given to a qualifying organization exempt from tax under IRC Section 501(c)(3) (i.e., a religious, charitable, educational, literary, or scientific organization); and (2) The value of donated services is not tax deductible. (For more information on what donations qualify for tax deductions, see IRS Publication 526, “Charitable Contributions,” at [www.irs.gov](http://www.irs.gov).)

In some situations, people want to seek grants or donations to compensate them for providing services to people who otherwise may not be able to afford them. Sometimes this would be a sideline of the service provider’s primary business. This also is not a valid reason to create a non-profit organization. The IRS frowns on this because of the likelihood that charitable funds will be used to benefit the private business and its owners. If you want to use your skills for disadvantaged people free or below cost, either volunteer with or do paid work part-time for an existing tax-exempt organization.

Accordingly, if you are providing professional services free or below cost, you cannot claim a tax deduction for the value of the services. (In the view of the IRS and state tax agencies, you are not entitled to a tax deduction for revenue you do not earn. This rule may not seem to encourage pro bono work by professionals, but that is the law.) If you are giving away a product free or below its value, you may be able to get a tax deduction for a charitable contribution if you provide the gifts to or through a tax-exempt charitable organization. If you want to distribute the product to people yourself, however, you will not be able to claim a charitable gift deduction.

#### **You feel your current work is not meaningful.**

Separate your career goals from the formation of a new organization. Finding meaningful work is a very important and commendable goal, but that alone will not justify starting a new organization. There are many attractive career opportunities with existing nonprofit organizations. Contact your local C-MAP partner for suggestions on how to conduct a job search in your area.

#### **You have important knowledge and perspectives to share.**

Think carefully about whether an organization is really needed. There may be more effective ways to get the word out, such as writing a book, speaking in public, or teaching.

#### **You want to do things your own way and not be fettered by rules and bureaucratic procedures.**

The hope that nonprofits offer such freedom is usually an illusion. As you will see, nonprofit organizations must be governed by a board of directors exercising their independent judgment about the best interests of the organization. If the board functions properly, this greatly diminishes the control any one person, even the founder, has over the organization. Further, as already mentioned, the Internal Revenue Service and foundation

and government grantmakers all demand that an organization show that it receives broad public support. Finally, nonprofit organizations are held to a higher standard than for-profit businesses in terms of broad public disclosure and reporting requirements and are subject to broad oversight by the IRS and the California Attorney General.



## Decision tree for launching a nonprofit organization

In this section we present a set of questions to help you explore whether forming a new nonprofit organization is the best way for you to accomplish your goal. As you address these questions, you will:

- Verify, define, and detail the need or opportunity you want to address
- Identify alternative ways to accomplish your goal
- Analyze and evaluate each alternative
- Choose the best alternative
- Re-test this alternative
- Implement your decision

People make decisions in different ways. You may not want to take on these questions in exactly the order in which we have presented them. Feel free to tackle first the question that seems most pertinent. Before you start a new organization, however, you need to be able to answer “yes” to each question. If you do, then you will be ready to form a new organization and can be confident that you can explain to potential supporters and donors why it was necessary to create a new organization (and they will ask).

To give alms is nothing unless you give thought also.

- John Ruskin

### Questions

- \* Is your proposed project something a nonprofit organization can legally do?
- \* Is there a demonstrated need for your project?
- \* Can you clearly state your mission?
- \* Have you carefully considered a partnership with an existing organization?
- \* Can you describe what success would look like?
- \* Can you describe how you will pursue your goal (the steps to success)?
- \* Will others (foundation and government grantmakers, individual donors, board members, and volunteers) commit time and resources to your cause?
- \* Do you and your supporters have the skills to start the proposed new organization?

### Is your proposed project something a tax-exempt organization can legally do?

We discuss acceptable purposes under Section 501(c)(3) further below, on page 14. As we have already mentioned, nonprofit organizations exempt from tax under Section 501(c)(3) must pursue a public benefit purpose. Accordingly, Section 501(c)(3) organizations cannot,



Life's most persistent and urgent question is, "What are you doing for others?"

- Martin Luther King, Jr.

among other things, (1) be operated for someone's private benefit, (2) support or oppose a political party or candidates for office or (3) have as the mission of the organization the achievement of something only possible by the passage of legislation. Note that running a business without paying income tax is never an acceptable purpose for a nonprofit organization, either as a legal or ethical matter.

### Can you demonstrate that the need or opportunity exists?

People start nonprofit organizations because they believe there is an opportunity to make a positive change or to enrich the quality of life. You probably see this need or opportunity very clearly. To raise the resources and support you'll need to be successful, you'll need to prove that you are right. Groups concerned with an issue often create an initial list of problems or needs based on their personal experience and observation alone. You need to gather good data and survey the opinions of others involved in your issue in the community to verify that the need or opportunity exists. Nonprofit organizations deal with vulnerable populations and difficult, sensitive issues from domestic violence to civil rights to the environment.

Dealing with these issues is serious business, and people who work in the nonprofit sector must be skilled and competent.

You need a broad understanding of your field and a detailed understanding of the specific situation that concerns you. Before you begin your research, take an hour to sketch out, just for yourself, the need you have identified and how you plan to address it. This will help you identify the questions you need to answer and the information you want to gather.

First, be sure you have a good general understanding of your field. Magazine and journal articles can be an excellent introduction. If you are not sure where to start, go to your local library and ask the librarian for assistance. Read everything you can on the topic. Learn what has been tried, what does or does not work. Get to know people who work in the field. Seek them out, discuss your idea, and listen to their reactions. Often they can provide you with valuable insights to develop your plan.

Use this background to study your specific situation. Compile both quantitative and qualitative information. You don't need to be a statistician or trained researcher to accomplish this. A great deal of information is available through public sources.

*"Facts are simple and facts are straight  
Facts are lazy and facts are late  
Facts all come with points of view  
Facts don't do what I want them to."*

"Crosseyed and Painless," Talking Heads

**Quantitative information** refers to statistics and numeric comparisons. For example, you may need to create a community profile by age, gender, crime rate, housing, income, education, cultural facilities, or employment and compare this to the situation in a broader region. Government agencies gather and make available a great deal of statistical information, much of it now available on the Internet. Learn what federal, state and local government agencies are involved in your area of interest and what they have available. Explore the information your United Way, other nonprofit organizations, and local universities have gathered. For sources of data, refer to the resources listed at the back of this book.

**Qualitative information** includes the opinions and experiences of knowledgeable and involved people. The most critical step is to meet with leaders and members of the community you wish to serve. These viewpoints and this leadership, not the opinions of outsiders, must drive your project. Gather their opinions and reactions to your project. Are they interested in your issue? Are they willing to help? Also discuss your project with nonprofit organizations and other groups working in the area. Might you be most effective by working with an existing program?

Sit down with everything you have gathered. Prepare your case. Review your original draft and back up each argument with facts. Then ask, “Have I demonstrated that the need exists?”

This may seem like a lot of work, but it will not be wasted. If you start a nonprofit organization, you will need this statement of the conditions you are trying to change (your “case statement”) for every proposal you write to a foundation, and to approach potential donors or recruit board members, employees and volunteers. Also, in the process of doing the research, you will meet people with whom you may want to collaborate in the future.

Mission is the star we steer by. Everything begins with mission, everything flows from mission. It is solely why we do what we do.

- Frances Hesselbein

### Can you clearly state your mission?

It is important to be able to define clearly the mission the organization will pursue. A mission statement should be short (suggested maximum of three simple sentences) and should quickly and clearly convey to readers the organization’s purpose.

A mission statement should include:

- Why? The purpose or essence of the organization; the change that will occur because of its existence.
- What? A brief description of the services provided by the organization that lead to the change or impact.
- Whom? The target population served by the organization.
- Who? The staff and/or volunteers that deliver the service-outlining any distinctive characteristics.
- Where? The geographic parameters that define your service area.
- How? The method by which the services are delivered.

The mission statement serves multiple audiences. Internally, it provides the focus and momentum for all activities within the organization. The mission statement also provides outsiders (funding sources, community members and constituents) with a concise statement about the organization, from which they can determine if they want to develop a relationship with your program.

If you have built castles in the air, your work need not be lost; that is where they should be. Now put foundations under them.

- Henry David Thoreau

A mistake that many groups make is to reduce their mission statement to the “betterment of humanity.” While no one disagrees that this is a worthy goal, it is not specific enough to describe your true mission. By providing specific information on the organization’s purpose, you help potential donors and volunteers to make an informed decision about whether to support your cause.

As the organization grows, you should monitor progress against those goals and objectives.

### Can you describe what success would look like?

Develop with your supporters a clear vision of what the world will look like if your program succeeds. What difference will your program make? If you cannot articulate a clear, compelling vision of your goal, you are not ready to begin a new organization. Prospective supporters will want a clear vision of where you are going, and of how you plan to get there.

### Can you describe how you will pursue your goal?

I have no plans, and no plans to plan.

- *Mario Cuomo, Governor of NY, on presidential ambitions, NY Times 14 Sep 86*

With your project vision in mind, create a clearly articulated statement of your purpose that others can understand. Then outline your plan to achieve this mission. Write out specific targets and outcomes you will use to measure your success in reaching each goal. Describe specific steps to accomplish each goal. How much time will each step take? What people, space, equipment, time, and money will it require? This plan should broadly map the future of your organization. If you need guidance on how to create a plan, consult your local C-MAP partner or other local management support organization, or consult one of the books in the bibliography at the back of this book.

You may not know every detail at the start; one purpose of this plan is to identify areas that need more research. It is best to work on this plan with your supporters. The group that has participated in the plan will be much more likely to provide future support, and the plan will be enriched by everyone's best ideas. If you start a nonprofit organization, some of these supporters will probably serve on your board, and will be responsible for helping guide the organization in following the plan. Keep in mind that you will need a budget, mission, and plan in order to complete the paperwork necessary to set up a nonprofit organization, as well as to request funding from foundations, government agencies, and individuals.

### Will others commit time and resources to your cause?

#### Potential sources of income:

Nonprofit organizations have a range of opportunities for financial support. Donations, grants, and non-cash assistance (also called in-kind contributions) may come from such diverse sources as government agencies, corporations, foundations, federated campaigns (such as United Way), churches, local businesses, fraternal or social clubs, or individuals. In addition, nonprofit organizations can earn revenue from charging reasonable fees for the services or products they provide in pursuit of their public benefit mission.

Depending on the source, assistance may include general operating funds, program-specific funds or non-cash assistance.

\* General operating funds are given to a nonprofit organization without any restriction on how the funds should be expended.

\* Program-specific or restricted funds are granted for restricted use on a specific activity sponsored by the nonprofit organization.

\* Non-cash assistance (also called in-kind contributions) is an alternative to cash support, and assumes a range of forms, including donation or loan of facilities, personnel, products and services, or technical assistance.

During their early years, nonprofit organizations most frequently rely on the support of individuals who give their time and money to the cause. This is similar to small business start-ups, in which entrepreneurs often get funds from friends and relatives. Groups who found successful nonprofit organizations often work very hard during the early years for little or no financial compensation. This brings home the point that nonprofit organizations are not solo crusades. Can you identify individuals who will support your organization in this way?

Support from individuals is especially critical to new organizations. As we pointed out earlier, even established organizations rely heavily on donations from individual supporters. It is a common misconception that foundation and government grantmakers will donate money to cover the costs of starting a nonprofit organization. In fact, instances of this type of funding are rare. Grantmakers receive many requests for support. They look for an established track record and clear evidence that the organization has a broad base of support.



### **Do you and your supporters have the skills best suited to starting the proposed new organization?**

Starting a nonprofit organization is demanding. Running an organization requires sound management and administrative skills. You need to know how to handle money, supervise others, and comply with all necessary laws and regulations. Few people have all the abilities necessary to grow an organization—but those who succeed know how to identify and involve a team of people who together possess the necessary balance of viewpoints and skills.

The ability to inspire others to get involved is crucial. You must want to work with others for the success of the organization. Perhaps most important, ask yourself if your commitment to the cause is greater than your personal need to run the organization. If the organization grows, and you no longer have the right set of skills, will you be willing to accept that it is time for you to move on in order to advance the cause?

#### ***A word about human resources***

To conduct the operations of your organization, you will need to rely on people: the board of directors and staff members, who may be volunteer or paid. For more information about the roles of board members, see pages 18-21.

Assess what your organization requires in terms of human resources (personnel) to deliver your organization's services, raise money, and provide administrative support. The assessment should focus on your needs today, in six months, and a year from now.

In each of these areas (service delivery, administrative support, and fundraising), you must consider what is needed to provide the service or function, what kinds of skills, expertise and licenses are necessary, when the service has to be provided, whether there are geographic considerations, and whether the function could be performed by volunteers.

Based on this analysis, you can develop job descriptions or position statements. Next, you should determine whether the task must be done by paid staff or could be done by a skilled, semi-skilled, or unskilled volunteer. Would a part-time staff person suffice? Is this task a project assignment, a short-term assignment, or an ongoing need?

### **Have you carefully considered a partnership with an existing organization?**

By now you should have encountered other nonprofit organizations that are working on your issue in your geographic area. If you are unsure how to locate such organizations, ask your local C-MAP partner, community foundation, United Way, or other local resource for suggestions. Get to know these organizations and their programs well. They are potential partners in your work.

Now comes the hardest part. Ask yourself if, in fact, no one else is working effectively on the issue. Is there truly an unmet need? Confront this question squarely. Suppress the desire to wriggle out of it because others are not doing exactly what you would like, or in the way that you would like. Can you join forces with another group? Nonprofit organizations attract fiercely independent people, which is good, but creating

As they say, "None of us is as smart as all of us." That is good because the problems we face are too complex to be solved by any one person or any one discipline.

- Warren Bennis

change is hard. You'll need allies. If there is already an organization that has a good board of directors and an established funding base, is there a clear reason to form another one? Could you work with an existing organization as a staff member, board member, volunteer, or donor? If you ask an organization with similar objectives to take on your project and you bring enthusiasm and a source of funds, you probably will be well received. You will need to fit into the existing organization (board of directors, officers, committees, budget cycle, etc.), but you will be saved the delay, expense and energy diversion of establishing a new organization, and you will probably benefit from the experience and connections of the other group.

If you do decide to start a new organization, will you be able to make a compelling case for grantmakers and other donors to fund the new organization and to divert funding dollars away from existing organizations serving the same or similar purposes? Charitable dollars are scarce. Are they best spent starting a new organization, or should they be used to strengthen an existing one?

Giving should be entered in just the same careful way as investing . . . Giving is investing.

- *John D. Rockefeller*

# The Legal Framework

## 2

If you have gone through the decision steps described in Chapter 1 and decided that it is best to form a new, independent nonprofit organization, you will need to prepare to choose a legal form for your organization and seek tax exemption. In the following pages, we will try to give you a basic introduction to the issues involved in (1) determining whether your organization will be eligible for tax exemption, and (2) selecting an appropriate form of legal entity.

In reading this outline, please keep the following in mind. When most people use the term “nonprofit organization,” they typically combine three separate and distinct characteristics:

- formal corporate status;
- nonprofit character; and
- tax exemption

As a result, many people assume that, for instance, forming a nonprofit corporation is the only way to obtain exemption from income taxes for their project or group, or that exemption from tax follows automatically from filing corporate papers. Neither is true. So, as you read about obtaining tax exemption and choosing a nonprofit legal structure, remember that a project or group can be nonprofit, yet be unincorporated, and that whether or not a group is exempt from tax is a matter of obtaining a tax-exemption designation from the federal and state tax authorities, regardless of the group’s corporate status.

Above all remember, as we noted above, the purpose of this book is not to instruct you on how to actually set up a nonprofit organization. To do that, we strongly urge you either to seek help from an attorney or to follow one of the self-help guides we recommend in the back of this book.

Back in the East you can’t do much without the right papers, but with the right papers you can do anything. They believe in papers. Papers are power.

- Tom Stoppard  
1937- : *Neutral Ground* (1983)



## Tax exemption for public benefit nonprofits

The preferred form of tax exemption is exemption under Section 501(c)(3) of the Internal Revenue Code (IRC). This is reserved for groups performing public benefit activities and refraining from significant political activism. Organizations exempt under Section 501(c)(3) do not pay income taxes, and donors to such corporations can deduct their contributions from their taxable income. Nonprofit organizations engaging in substantial lobbying or legislative advocacy can be exempt under IRC Section 501(c)(4) from paying tax on what they take in, but their donors cannot deduct contributions from their taxable income.

We will very briefly discuss exempt purposes under Section 501(c)(3), followed by a short description of exempt purposes under Section 501(c)(4).

### Section 501(c)(3) tax-exempt purposes:

In a nutshell, tax-exempt status under Section 501(c)(3) is available to organizations whose purposes are:

- charitable (as the IRS defines this, which is not necessarily our common sense of the term)
- religious
- educational
- scientific
- literary
- testing for public safety
- fostering national or international amateur athletic competition
- preventing cruelty to children or animals

We will briefly go into further detail about charitable and educational purposes, as most groups we encounter fall into these broad categories.

#### 1. Charitable purposes:

Broadly defined, “charitable purposes” means activities beneficial to the public interest and serving an open class of people, not a limited number of identified people. Examples of charitable purposes include:

- relieving the poor, distressed or underprivileged;
- advancing education or science (distinct from providing instruction, which would be an educational purpose);
- erecting or maintaining public buildings, monuments or works;
- lessening the burdens of government;
- eliminating prejudice and discrimination;
- promoting and developing the arts; or
- defending human and civil rights secured by law.

For example, organizations pursuing community development, which can include job training, economic development, developing affordable housing, and so on, may qualify for exemption under one or more of the following: relieving the poor and distressed, combating community deterioration and/or eliminating discrimination, and lessening the burdens of government.

It's all papers and forms, the entire Civil Service is like a fortress made of papers, forms, and red tape.

- Alexander Ostrovsky,  
*The Diary of a Scoundrel*,  
1868

## 2. Educational purposes:

The IRS defines “educational” more narrowly than we might expect. “Educational” in this context means instruction of individuals or the public for the purposes of improving or developing their capacities. Other education-related purposes generally must qualify under the broader notion of charitable purposes described above. (For example, a group providing community health education would qualify as charitable, rather than educational.) The IRS allows a curriculum to present particular viewpoints if there “is sufficiently full and fair exposition of pertinent facts to permit an individual or the public to form an independent opinion or conclusion.” However, mere presentation of unsupported opinion is not considered educational. Some examples of educational purposes include:

- publishing public interest educational materials;
- conducting public discussion groups, forums, panels, lectures, workshops, etc.;
- offering a correspondence course or one that uses other media such as television or radio;
- operating a museum, zoo, planetarium, symphony orchestra, performance group, etc.;
- publishing educational newsletters, pamphlets, books or other material;
- operating a college bookstore, alumni association or athletic organization for the benefit of, and controlled by, an educational institution.

For a full discussion of the requirements for exemption under Sections 501(c)(3), 501(c)(4) and other tax exemptions, see IRS Publication 557, “Tax-Exempt Status for Your Organization.” (Believe it or not, this IRS publication is fairly accessible and well written.) You can download it from the Web at [www.irs.gov/formspubs/index.html](http://www.irs.gov/formspubs/index.html). The IRS web site also has a resource page called “Tax Information for Charities and Other Non-Profits,” which can be found at [www.irs.gov/charities/index.html](http://www.irs.gov/charities/index.html).

### **Section 501(c)(4) Tax-exemption for social welfare organizations**

Another category of tax-exempt, charitable organization includes social welfare organizations or civic leagues. These organizations receive slightly different tax treatment than Section 501(c)(3) organizations because their activities are directed more toward influencing public opinion and the legislative process. Tax exemption is offered to such groups under IRC Section 501(c)(4) if they have educational, charitable, or recreational purposes and “operate primarily to further (in some way) the common good and general welfare of the people of the community (such as by bringing about civic betterment and social improvements).” Often the feature that characterizes an organization as exempt under Section 501(c)(4), rather than Section 501(c)(3), is the degree to which the organization pursues changes in public policy.



## Incorporation and alternatives

There are three basic ways to structure an independent charitable organization under current California law. Your organization may form an unincorporated association, a trust, or a nonprofit corporation. A fourth option would be to “incubate” a new program under a fiscal sponsor (further described in the “Alternatives to Incorporation” box below).

An unincorporated association may fit the needs of a small organization whose activities do not pose liability concerns and that is not required to file applications

### Alternatives to incorporation

You do not necessarily need to form a nonprofit corporation to pursue a new project’s program and fundraising activities. You may be able to operate periodic, short-term activities, such as an annual car wash or bake sale, without forming an organization. For other small projects, forming an unincorporated association may be appropriate. For more involved projects in which there may be a greater need for liability protection and accountability, you can consider collaboration with an existing organization or fiscal sponsorship.

#### Unincorporated association

For small or short-term projects, an alternative is to form an unincorporated association. An incorporated association is simply a group of two or more people sharing a common goal. Groups often choose to be unincorporated associations if they are only going to be in operation for a short period. Unincorporated associations are informal and easy to organize. If a program would qualify by the nature of its service for tax-exempt status and its annual gross revenue is less than \$5,000, then the organization may proceed as if it were tax-exempt without filing an exemption application with the IRS, and can provide contributors with tax deductions for their contributions. If it is necessary to obtain an exemption, however, the organization might as well form a corporation, since it will have to apply for tax exemption anyway.

The primary disadvantages of unincorporated associations are: (1) in certain circumstances, directors and members may be held personally liable as individuals not only for their own actions or omissions but also those of other directors and members; and (2) the law governing unincorporated associations is not as clear as that for nonprofit corporations; unincorporated associations are dealt with indirectly through the law governing mutual benefit membership organizations. Despite these disadvantages, an unincorporated association may fit the needs of small organizations pursuing exempt purposes that are not required to file applications for tax exemption because their annual revenues are less than \$5,000 and whose activities do not pose liability concerns.

#### Fiscal sponsorship (“Incubators”)

Some nonprofit organizations are willing to serve as fiscal sponsors for new projects whose goals are similar to the sponsoring organizations. Further, some organizations provide such support as a core feature of their charitable mission, serving as “incubators” providing a supportive environment to nonprofit organizations during their initial stages of development. In addition to vouching for the public benefit, tax-exempt nature of the project, these organizations also provide services including planning, financial management, personnel and legal assistance.

for tax exemption because its annual revenues are less than \$5,000. (See the inset box “Alternatives to incorporation” for a further description of unincorporated associations.)

A “trust” is designed to hold assets for a specific purpose, but the restrictions on a trust’s activities and the duties and potential liabilities of trustees are significantly greater than for directors and officers of California nonprofit corporations.

For most nonprofit groups based in California, the best legal structure is the California nonprofit corporation. Nonprofit corporations offer the advantage of limited personal liability for directors and officers, and the law governing nonprofit corporations is clear, providing well-defined rules for public benefit, mutual benefit and religious organizations.



## Advantages of incorporation and tax exemption

**C**orporate and tax-exempt status offer public benefit nonprofit corporations some important benefits, including:

- **Limited Liability:** A primary advantage of forming a corporation (or coming under the fiscal sponsorship of one) is that corporations offer the protection of limited liability to corporate directors and officers. This is especially important if the organization will be taking in and expending significant sums of money, buying property, hiring employees, or entering into leases and contracts. What limited liability means is that the organization’s directors and officers have limited personal liability for business debts. Creditors can only go after corporate assets and insurance to satisfy liabilities incurred by the corporation.
- **Exemption from Income Tax:** If the corporation satisfies federal and state requirements, the corporation will not have to pay income taxes. This will be discussed more extensively below.
- **Contributions Are Tax Deductible:** If there are other private persons or entities that want to contribute to your 501(c) 3 organization, they may deduct contributions from their taxable income, so they do not pay taxes on what they give you. This is a great tool for encouraging contributions.

It takes a noble man to plant a seed for a tree that will someday give shade to people he may never meet.

- *David Trueblood*



## What is a nonprofit corporation?

**A** nonprofit corporation is one that is organized and operated for one of the nonprofit purposes recognized under state corporation law. What makes a corporation nonprofit is that:

- the mission of the corporation is to undertake activities whose goal is not primarily to earn a profit;
- no person owns shares of the corporation or interests in its property; and
- the property and any income of the corporation are not distributed to any owners, but instead are recycled into the corporation’s activities.

(See “Key characteristics of nonprofit organizations” on page 2.)



### What is a corporation?

A corporation is an imaginary thing, a “legal fiction.” (For example, a company like General Motors is really nothing but a collection of people consisting of shareholders, who are the owners, directors, and officers who control it, and employees, and the legal rights and duties that tie them together.) A corporation is treated as legally separate from the people who own, manage and operate it. The corporation is able to enter into contracts and incur debts, and must pay taxes like any person. The corporation’s rights and obligations are separate from those of the people who own or run the corporation. In other words, if the corporation were to lose a lawsuit, the people who work there, manage, or own it would typically not be personally financially accountable, with some exceptions.

California recognizes three types of nonprofit corporations. They are public benefit, mutual benefit (benefiting members only), and religious. Since our purpose here is to assist in the creation of groups intended to promote public benefit purposes, we will discuss only public benefit nonprofit corporations.

Examples of groups with public benefit purposes include childcare centers, shelters for the homeless, community health care clinics, museums, hospitals, schools, performing arts groups, conservation groups, and low-income housing groups, to name a few. We will discuss various definitions of public benefit purposes further in the next section.



## How nonprofit organizations work

**N**onprofit organizations are creatures of state corporate law and are subject to federal and state tax law. The law in each area imposes duties on nonprofit organizations and their managers and directors, which we will describe briefly below.

### Oversight by Attorney General and Internal Revenue Service

Because charitable corporations are supposed to serve public ends, the Attorney General of the State of California is given broad jurisdiction to supervise public benefit corporations. The Attorney General may investigate public benefit corporations at any time to see whether they have departed from their charitable purposes. Further, public benefit corporations must notify the Attorney General of the sale or transfer of all or substantially all of the corporation’s assets, a decision to dissolve, or other important events.

The federal Internal Revenue Service and the state Franchise Tax Board each have the authority to withhold or remove an organization’s tax exemption and impose penalties on the organization and its directors and managers. Loss of tax exemption, while not certain doom, is difficult to overcome.

### Governance by Boards of Directors

Under California law, directors bear all legal authority and responsibility for governing a nonprofit organization (“The buck stops here,” in President Truman’s words). While it is rare, board members of California nonprofit public benefit corporations can be held personally liable for breach of their duties to the corporation and to third parties, as described below. Careful attention to the legal standard of care will help board members avoid liability.



To meet the legal standard of care, directors must act:

- in good faith in what they believe to be the best interests of the organization, (“the duty of loyalty”);
- with such care, including reasonable inquiry, as an ordinarily prudent person would use in similar circumstances, (the “duty of care”).

While these duties sound stringent, the law does not expect perfect decisions. Directors and managers are protected by a “Business Judgment Rule,” which holds that directors and managers cannot be held liable for poor decisions, even if their decisions hurt the organization, if they meet the following criteria:

- meet the standard of care (“prudent person” or “care appropriate to the circumstances”);
- reasonably and in good faith rely on information from officers, employees or professionals; and
- follow the proper procedure for approving any transaction between the nonprofit and its directors.

The purpose of this rule, both for standard business corporations and nonprofits, is to relieve directors of the fear of being second-guessed by courts. Directors should be required to make carefully considered decisions, but not to have perfect foresight.

Directors, of course, also owe a duty of care to third parties to avoid injuring people or property through their decisions. This duty arises when directors become aware, or should be aware, of a situation in which it is foreseeable that someone may be hurt. If the directors then fail to take reasonable steps to prevent that foreseeable harm, they may be liable if the harm results. For example, if directors of a childcare center know that the roof is failing, they must either fix it or find another site for the children. Another example might be the duty to take reasonable steps to investigate allegations of sexual harassment or employment discrimination.

When do any of us ever do enough?

- Barbara Jordan

## Governance by group decision

By law, boards of directors must act as a group. Decisions must be made not by individual directors, but by the whole board or a committee of the board authorized to act on behalf of the board on the matter in question. Boards generally make decisions using either a majority vote (51% of the board members present at a meeting assuming quorum has been established), consensus, or fluctuate between these modes. How boards make decisions is in many ways determined by the profile of the group and the organization’s culture and values.

## Roles and responsibilities of directors and managers

It is often said, “Boards make policy, and management implements policy.” Unfortunately, such statements confuse more than they explain, primarily because they do not illustrate the difference between a policy decision appropriate for the board of directors and a choice of implementation options appropriate for the executive director and management.

While individual organizations may define these roles differently, the most common separation of roles would be something like this:

Responsibility	Board of Directors	Executive Director or Officers
Legal	<ul style="list-style-type: none"> <li>■ Exercises fiduciary role to ensure that the organization is properly managed. The Board should have a mechanism to validate information from the Executive Director.</li> <li>■ Maintains corporate status; ensures that proper paperwork is submitted to governmental agencies.</li> <li>■ Reviews financial and business dealings to protect the organization from lapsing into private foundation status and exercises proper judgment in self-dealing transactions.</li> </ul>	<ul style="list-style-type: none"> <li>■ Must provide information to the Board to demonstrate that the organization is well managed.</li> <li>■ Compiles information for annual filing requirements. Signals if either of these situations is likely to occur.</li> </ul>
Finance/ Accounting	<ul style="list-style-type: none"> <li>■ Approves annual budget.</li> <li>■ Reviews periodic financial reports (balance sheet, income statement, changes in financial position).</li> <li>■ Ensures that proper internal controls are in place.</li> </ul>	<ul style="list-style-type: none"> <li>■ Prepares annual budget with input from staff and accounting department (depending on size of organization).</li> <li>■ Oversees preparation of periodic financial reports.</li> <li>■ Implements proper financial controls.</li> </ul>
Planning	<ul style="list-style-type: none"> <li>■ Establishes mission and program direction for organization.</li> <li>■ Reviews program plan and progress. Conducts or reviews program evaluation plan.</li> </ul>	<ul style="list-style-type: none"> <li>■ Develops specific program goals and objectives based on the board-specified mission.</li> <li>■ Develops reports or oversees staff development of reports to demonstrate program progress.</li> </ul>
Policy	<ul style="list-style-type: none"> <li>■ Sets policy.</li> </ul>	<ul style="list-style-type: none"> <li>■ Implements policy (the specific operational decisions are the staff's responsibility).</li> </ul>
Personnel	<ul style="list-style-type: none"> <li>■ Elects officers</li> <li>■ Hires Executive Director/ Officer and evaluates performance.</li> <li>■ Reviews personnel policies.</li> </ul>	<ul style="list-style-type: none"> <li>■ Implements personnel policies.</li> <li>■ Hires all other personnel and evaluates performance of staff members (or delegates to appropriate supervisor).</li> </ul>
Resource Development	<ul style="list-style-type: none"> <li>■ Establishes fundraising goals and participates in fundraising efforts.</li> <li>■ Determines feasibility of fundraising goals.</li> </ul>	<ul style="list-style-type: none"> <li>■ May conduct research and assist in fundraising goals.</li> <li>■ Directs staff assistance with fundraising efforts.</li> </ul>
Board Governance	<ul style="list-style-type: none"> <li>■ Oversees maintenance of minutes, attendance records, and deals with board members who have lapsed in responsibilities</li> <li>■ Recruits new board members (in non-membership corporations)</li> </ul>	<ul style="list-style-type: none"> <li>■ Office staff may assist with preparation and distribution of minutes.</li> <li>■ May suggest names for consideration.</li> </ul>

## Board composition

### *How big should the board be?*

Most nonprofit organizations have discovered that a board size of 5 to 18 members provides a cross-section of skills and expertise, yet still is manageable. This number of directors can offer broad community representation and expertise for the organization.

The ideal size of the board will depend on the specific needs of your organization. The board should be large enough to obtain broad-based community support and input, yet small enough to be efficient.

### *Should employees be board members?*

Although California law allows employees to serve as board members, in practice, nonprofit organizations rarely have employees on the board, with the possible exception of the executive director. Having an employee on the board is not recommended. It increases the potential for conflicts of interest. Perhaps most important, it may interfere with the board's ability to oversee and evaluate the chief executive's performance. Also, because the executive director reports to the board, having employees who report to the executive director also serve on the board can confuse the lines of decision-making within the organization.

There are other ways for board members to work with and receive information from employees. Employees can serve on board committees, attend joint board and staff retreats, and contribute to the evaluation of the executive director. Many funders (including certain government departments, United Ways, and many foundations) will not fund organizations that have employees serving as board members.

### *Should board members be paid?*

Although it is legal in California for board members to be paid reasonable compensation for their service, board members of nonprofits usually serve as volunteers. In fact, the growing trend is for board members to make personal financial contributions to the organization on whose board they are serving. Under California law, it is legal for up to 49% of a nonprofit public benefit organization's board to also serve the same organization as employees or contractors. For example, if there are five directors on a board, no more than two can receive payment as an officer, employee, or provider of professional services, such as an attorney or accountant. Board members can receive reimbursement of reasonable expenses, such as travel, for their board service.

## Reporting and Disclosure Requirements

Contrary to many people's perceptions, nonprofit organizations are subject to extensive reporting and disclosure requirements, in some cases well beyond those imposed on for-profit enterprises (except in the area of securities regulation, which typically does not affect charitable organizations). The following is an outline of the key reporting requirements:

### Federal Corporate Tax Returns: Form 990

A nonprofit corporation with tax-exempt status must file annual returns on IRS Form 990 within four and a half months following the close of its fiscal year. Certain organizations are exempt from this filing requirement, including churches and organizations (other than private foundations) that normally have gross receipts below \$25,000.

### Secretary of State Filing and Reporting Requirements

- 1) California nonprofit public benefit corporations must file an annual Statement by Domestic Nonprofit Corporation, containing the names and addresses of its chief executive officer, secretary, and chief financial officer; the street address of its principal California office; and designation of the person authorized to receive official notices for the corporation.
- 2) In the event of amendment to the articles of incorporation, or an election to merge or dissolve the corporation, a nonprofit must file a certificate of the resolution of the board to take such action, attested to by the secretary of the corporation.

### Reports to the Attorney General

- 1) Nonprofit public benefit organizations, other than religious organizations, hospitals, or private schools, with revenues or assets over \$25,000 must file:
  - a) an annual RRF-1 notice (\$25 filing fee), and
  - b) a copy of their informational tax return to the IRS (IRS Form 990, 990-EZ or 990 PF) with the Attorney General's Registrar of Charitable Trusts no later than four months and fifteen days after the end of the organization's fiscal year. The franchise tax exemption of any charitable corporation may be disallowed for any year for which it fails to file a report.
- 2) Any major change in the form of the corporation (e.g., a merger or a disposition of substantial assets) not in the usual course of the corporation's activities requires a written notice 20 days in advance of such an event.

### State Tax Returns - California Franchise Tax Board Form 199

California nonprofits, other than religious groups and organizations (other than private foundations) with annual gross receipts normally less than \$25,000 are required to file Form 199.

### Public Inspections

All organizations exempt under IRC Section 501(c)3 or 501(c)4, including private foundations, must make available upon request, by mail or via the Internet, the following documents:

- 1) copies of the exemption application (Form 1023) submitted to the IRS;
- 2) copies of the three most recent informational returns to the IRS (Form 990); and
- 3) papers submitted in support of these documents (the names and addresses of donors need not be disclosed).

The organization may post copies of these materials on the Internet, rather than mailing copies within 30 days of request, so long as the materials are widely available; that is, the organization tells people requesting these materials or visiting the organization's Web site where to find the materials on the Internet (such as on their own Web site or a public database like Guidestar ([www.guidestar.org](http://www.guidestar.org))), and the materials may be downloaded free of charge.

Incomprehensible jargon is the hallmark of a profession.  
- Kingman Brewster,  
U.S. Ambassador to  
Britain



## You can do it: Incorporating should be affordable and fairly painless

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**Y**ou can perform all the legal work of forming a nonprofit corporation yourself, or you can seek the help of an attorney. Seeking help from an attorney experienced in representing nonprofit organizations may well save you much time and potential frustration. If you cannot afford an attorney and do not feel comfortable incorporating the organization yourself, contact your nearest management support organization, such as the C-MAP partners listed in this booklet, for referral to a pro bono or legal aid organization that may be able to help you.

Regardless of whether you do it yourself or use an attorney, we strongly recommend that you look at a copy of *How to Form a Nonprofit Corporation in California* or *The California Nonprofit Corporation Kit*, both published by Nolo Press and written by Anthony Mancuso, Esq. You should be able to find either or both of these at your library, at a good local or online bookstore, or at [www.nolo.com](http://www.nolo.com). The book or kit will take you step-by-step through the process of forming a nonprofit corporation and applying for tax-exempt status. Even if you're going to have an attorney do the work for you, reviewing these materials will give you a much better understanding of the process than our short overview. Following the guidelines in the book or kit also may reduce your legal fees by saving time you otherwise would be charged for asking basic questions of the attorney or having them prepare supporting materials you could prepare yourself.

***Consult your tax attorney or accountant for further information on federal and state tax issues and state corporate law requirements.***

What is success? I think it is a mixture of having a flair for the thing that you are doing; knowing that it is not enough, that you have got to have hard work and a certain sense of purpose.

*-Margaret Thatcher*

## Steps to incorporation and tax exemption\*

1. (Optional) Clear and reserve, if desired, the name of the corporation with the Secretary of State's office.
2. Draft the articles of incorporation and file them with the Secretary of State's office. The articles of incorporation announce the formation of the corporation and give its broad purposes.
3. Draft and adopt bylaws for the corporation. Generally, the bylaws are the "constitution" of the organization. They set out the ground rules and operating procedures for the activities and conduct of the corporation. Actions taken in violation of the bylaws also may be declared invalid or challenged, which could hurt the organization. It is very important for organizations to comply with their bylaws in order to protect their corporate status and the limitation of liability that comes with it.
4. At the first meeting of the board, the directors must approve certain activities necessary to set up and run the nonprofit's operations, and must give specified people ("officers") the authority to do those things. For example, the directors should:
  - Accept their election as directors (if they did not already do so when the articles were filed);
  - Approve the bylaws;
  - Elect officers to run the corporation's day-to-day operations;
  - Authorize officers to prepare and present to the board a budget, and to seek federal and state tax exemption (if this has not yet been done);
  - Authorize officers to set up bank accounts for the corporation to purchase insurance, lease office space, etc.;
  - Create a committee of the board to research and recommend to the board appropriate compensation amounts (wages or salary) for the officers;
  - Adopt a policy regarding conflicts of interest, if not already included in the bylaws;
  - Determine the exact location of the principal office; and
  - Ratify steps previously taken by organizers to create the corporation and pursue tax exemption.
5. Create a minutes book in which you will keep the minutes of your Board of Directors' meetings, and enclose copies of the bylaws, articles of incorporation and the minutes of the board's first meeting. (The minutes book can be a form book obtained at an office supply store, or even a simple three-ringed binder; the important thing is to keep records of meetings and important decisions where you will be able to find them.)
6. Apply for federal tax exemption under IRC Section 501(c)(3) or 501(c)(4), using IRS Form 1023 for 501(c)(3) exemption or Form 1024 for 501(c)(4) exemption. Visit the IRS Website at <http://www.irs.gov> to download a copy, or call the IRS at 1-800-829-3676 to obtain the form.
7. Apply for California franchise tax exemption, using FTB Form 3500. You can download or order the forms from the Web at <http://www.ftb.ca.gov>. If you have any questions, call the California Franchise Tax Board at (800) 852-5711.

Accomplishing all these steps can take from two to nine months or more (especially depending on how long the IRS and California Franchise Tax Board take to review your applications for tax exemption) and can cost \$555 or more in filing fees, not including any professional fees for an attorney or accountant.

\*These steps illustrate the process in California. Incorporation process may differ in other states.

# Resources

# 3

## Publications

Attorney General, State of California. *Attorney General's Guide for Charities*. San Francisco, CA: California Department of Justice, 1998. Free.

This guide provides information on California and federal laws that govern nonprofit organization, defines the steps to apply for tax-exempt status, and lists additional services and publications.

Internet: <http://caag.state.ca.us>

Write: Office of the Attorney General, Public Inquiry Unit, PO Box 944255, Sacramento, CA 94244-2550

Internal Revenue Service. *Publication 557-Tax-Exempt Status for Your Organization*. Washington, DC: Internal Revenue Service, 1997. Free.

This publication discusses the rules and procedures for applying for exemption from federal income tax, filing requirements, and required disclosures.

Internet: [www.irs.gov](http://www.irs.gov)

Telephone: Your local IRS office.

Mancuso, Anthony. *How to Form a Nonprofit Corporation in California, 10th ed.*, Berkeley, CA: Nolo Press, 1998.

This handbook explains the legal and practical implications of incorporating a nonprofit organization. It includes California-specific legal and tax requirements and step-by-step instructions and tear-out forms and a CD-ROM with forms for applying for tax exemption, articles of incorporation, sample bylaws, and minutes. Nolo also publishes *The California Nonprofit Corporation Kit* that includes a binder in which to organize corporate records.

Internet: [www.nolo.com](http://www.nolo.com)

Telephone: 800-992-6656



## Internet resources

### **Internal Revenue Service** <http://www.irs.gov>

The IRS website provides answers to frequently asked questions about tax-exempt organizations. The site provides a step-by-step review of what an organization needs to know to file for tax-exempt status, whether they are eligible to receive tax-deductible charitable contributions and annual filing requirements for tax-exempt organizations. Publication 557 and other federal forms for nonprofit organizations can be downloaded directly from the site.

### **Internet Nonprofit Center** [www.nonprofit-info.org](http://www.nonprofit-info.org)

The Internet Nonprofit Center offers information for and about nonprofit organizations. Searching on the keyword “start-up” in the Nonprofit FAQ section of the site will direct users to information about how to start a nonprofit. The information includes how to incorporate an organization, the type of legal help needed and estimates on legal fees, setting up foundations, and obtaining a bulk mail permit. The site also offers advice on how to operate the organization before it is incorporated and how to create a budget for IRS Form 1023 Exemption Application.

### **The Nonprofit Genie** [www.genie.org](http://www.genie.org)

The Genie is a project of the California Management Assistance Partnership. This site gives you:

- Answers to your questions about fundraising, boards, financial management, and much more.
- Opinions from grantmakers, management experts, and nonprofit leaders.
- Links to the best nonprofit Web sites.

### **The Foundation Center** <http://fdncenter.org>

The Foundation Center Web site identifies a number of useful resources for start-up nonprofit organizations. It points users to web resources and recommended books specific to those wanting to incorporate a nonprofit organization. It also provides general information that may be useful including user aides for specific types of charitable organizations and information on special events, fundraisers, and proposal writing.

## Organizations

### **California Management Assistance Partnership (C-MAP)**

<http://www.c-map.org>

C-MAP, the California Management Assistance Partnership, is a consortium of 15 regional, nonprofit support organizations providing training and technical assistance to local nonprofits. Each of these organizations provides workshops in nonprofit management and fundraising and information and referral to local community resources. Some partners also offer computer workshops, provide consulting services, host conferences and other events, and publish books and informational materials.





