

BoardSource has been answering governance-related questions posed by nonprofit leaders for more than 25 years. Here are answers to some of the most frequently asked questions about starting a nonprofit.

How do we go about starting a nonprofit?

Every nonprofit organization must have a carefully developed structure and operating procedures to be effective at fulfilling its purpose. Good governance starts with helping the organization begin on a sound legal and financial footing in compliance with the numerous federal, state, and local requirements affecting nonprofits.

Here's a list of things you must do:

- **Determine the purpose of the organization.** Every organization should have a written statement that expresses its reason for being. Resources: Board members, potential clients, and constituents.
- **Form a board of directors.** The initial board will help translate the ideas behind the organization into reality through planning and fundraising. As the organization matures, the nature and composition of the board will change.
- **File articles of incorporation.** Not all nonprofits are incorporated. For those that do wish to incorporate, the requirements for forming and operating a nonprofit corporation are governed by state law. Resources: Your secretary of state or state attorney general's office.
- **Draft bylaws.** Bylaws — the operating rules for the board — should be drafted and approved by the board early in the organization's development. Resource: An attorney experienced in nonprofit law.
- **Develop a strategic plan.** The strategic planning process helps you express a vision of the organization's potential. Outline the steps necessary to work toward that potential, and determine the staffing needed to implement the plan. Establish program and operational priorities for at least one year. Resources: Board members, planning and management consultant.
- **Develop a budget and resource development plan.** Financial oversight and resource development (e.g., fundraising, earned income, and membership) are critical board responsibilities. The resources needed to carry out the strategic plan must be described in a budget and financial plan. Resource: Financial consultant.

- **Establish an accounting system.** Responsible stewardship of the organization's finances requires the establishment of an accounting system that meets both current and anticipated needs. Resource: Certified public accountant experienced in nonprofit accounting.
- **File for an Internal Revenue Service determination of federal tax exempt status.** Nonprofit corporations with charitable, educational, scientific, religious, or cultural purposes have tax-exempt status under section 501(c)(3) — or sometimes section 501(c)(4) — of the Internal Revenue Code. To apply for recognition of tax-exempt status, obtain form 1023 (application) and publication 557 (detailed instructions) from the local Internal Revenue Service office or from the IRS Web site. The application is an important legal document, so it is advisable to seek the assistance of an experienced attorney when preparing it. Resources: Your local IRS office and an attorney.
- **File for state and local tax exemptions.** In accordance with state, county, and municipal law, apply for exemption from income, sales, and property taxes. Resources: State, county, or municipal departments of revenue.
- **Meet the requirements of state, county, and municipal charitable solicitation laws.** Many states and local jurisdictions regulate organizations that solicit funds within that state, county, or city. Usually compliance involves obtaining a permit or license and then filing an annual report and financial statement. Resources: State attorney general's office, state department of commerce, state or local department of revenue, or county or municipal clerk's office.
- **Establish a record keeping system for the organization's official records.** Corporate documents, board meeting minutes, financial reports, and other official records must be preserved for the life of the organization. Resources: Your secretary of state or state attorney general's office.
- **Other steps.** Obtain an employer identification number (EIN) from the IRS, register with the state unemployment insurance bureau, apply for a nonprofit mailing permit from the US Postal Service, and obtain directors' and officers' liability insurance.

What is an Employer Identification Number?

All nonprofit corporations and exempt organizations, with or without employees, must have a nine-digit Employer Identification Number (EIN). This number can be considered the Social Security number for your organization. It is the reference number that you must use whenever communicating with the federal government. Form SS-4 is the form used to apply for an EIN.

What is an IRS determination letter?

A determination letter is the most important legal document your organization possesses. The IRS sends you this letter after you have successfully applied for the recognition of your

organization's tax-exempt status. In this document, the IRS indicates under which section of the Internal Revenue Code your organization is qualified.

For instance, if you file Form 1023, you expect to be recognized as a 501(c)(3) tax-exempt organization. To avoid revocation of your status, your organization must continue operating according to the manner you described in your application.

The determination letter is the only official document and proof that your organization is recognized as a tax-exempt organization. Keep it in a safe place.

Do all nonprofits have to apply for recognition of tax exemption?

No. Three groups are automatically exempt from filing an application: churches, organizations with gross receipts of less than \$5,000, and affiliates of existing nonprofits covered by group exemption. All other nonprofits must file if they want to be formally recognized by the IRS as tax-exempt organizations.

The IRS automatically recognizes several types of groups as public charities. These include (besides the special category of churches) certain educational institutions, hospitals and medical research organizations, public safety organizations, certain government organizations, and “supporting” organizations. Any other organization, if able to show that it is publicly supported, is granted a 501(c)(3) status. Public support means that the organization is successful in raising funds from numerous sources, has a diverse board, or provides services that appeal and are accessible to the general public. As the definitions of some of these terms are not necessarily self-explanatory, it is always wise to officially obtain a determination letter from the IRS as soon as possible. It is the only way you can prove your status.

Can a nonprofit's tax-exempt status be recognized retroactively?

A nonprofit must file its Form 1023 within 27 months after its incorporation. The original regulations specify an initial 15-month waiting period, but the IRS automatically extends this by another 12 months. If the nonprofit makes the deadline and receives a determination letter, the IRS recognizes the organization as a tax-exempt entity from its inception — the date when it registered its organizing documents with the state. If it misses the deadline, the organization will be recognized as a tax-exempt entity from the day the application was mailed.

Can we raise money before receiving our determination letter?

If you are expecting your organization to be recognized as a 501(c)(3) public charity, it will ultimately be able to receive tax-deductible donations. Before your determination letter arrives from the IRS, you can prepare for fundraising. Draft your documents and brochures. Research potential donors and foundations. Create your fundraising plan.

If you do any active fundraising before your status is cleared, it is necessary to let the potential donors know that your application for the tax-exempt status is pending and contributions are not tax-deductible before your determination letter has arrived. Most foundations won't be interested in considering your application until you can provide your determination letter.

However, if you filed with the IRS on a timely basis, the favorable determination on the part of the IRS is retroactive to the date of formation of the entity. Therefore, upon receipt of a favorable determination from the IRS, all of those donations received in advance of the favorable determination will be tax deductible.

What should be included in your articles of incorporation?

Your articles of incorporation are a binding legal document. The content requirements vary from state to state and, as a general rule, you should include only what the law requires. Your bylaws, which are more easily amended, will handle more detailed policies to govern your organization.

Normally, you would include the following items in your document:

- Name of the corporation
- The organization's specific purpose (be brief and broad to allow for future evolution, but clearly indicate its tax-exempt focus)
- Duration of the corporation's existence (often perpetuity)
- Location of the organization's office
- Number, names, and addresses of the initial board of directors
- Whether or not this is a membership organization
- Provisions for distribution of assets when the corporation is dissolved

What is a Unified Registration Statement (URS)?

Any nonprofit involved in far-reaching fundraising campaigns knows the pain and agony of having to register in every state where it engages in raising funds. Each state seems to have different regulations, different forms, and different fees. This process can turn into a bureaucratic nightmare.

The National Association of State Charity Officials and the National Association of Attorneys General have created a standard form of registration, which presently is accepted by the District of Columbia and 36 states requiring charities to register. This form can simplify the process

considerably. You can download the form and instructions, as well as the list of participating states.

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Why do we need a mission statement?

Every organization needs to define its fundamental purpose, philosophy, and values. The mission statement answers the basic question of why the organization exists and describes the needs the organization was created to fill. Without the guidance of a mission statement, programmatic priorities are difficult to establish.

The mission statement provides the basis for judging the success of an organization and its programs. It helps to verify if the organization is on the right track and making the right decisions. It provides direction when the organization must adapt to new demands. Attention to mission helps the board adhere to its primary purpose and serves as a touchstone for decision making during times of conflict. The mission statement can also be used as a tool for resource allocation. A powerful mission statement attracts donors, volunteers, and community involvement.

What is a vision statement?

Through a vision statement, a nonprofit defines its ultimate motivation, its dreams, and its image of a desired future. A vision statement describes the situation if the organization fulfills its mission.

Examples of vision statements:

“No child in our city will go hungry to bed in the evening.” (Soup kitchen)

“We will be recognized as the best symphony orchestra in America.” (Symphony orchestra)

How can our for-profit company become a nonprofit?

If you have a for-profit company and want it to become a nonprofit organization, you need to go through the same process as you would to form a nonprofit. This means the following must be done:

- Study the state laws and the IRS regulations that cover nonprofit and tax-exempt organizations. Learn what the main differences are between a for-profit company and a nonprofit organization. Make sure you can accept these expectations and structure and can operate your organization accordingly.
- Apply for the recognition of your tax-exempt status with the IRS by filing Form 1023 or 1024.
- Rewrite your Articles of Incorporation and file them with the office of your secretary of state.
- Rely on legal counsel when transferring the assets of your present company to the new nonprofit organization — unless, as the owner, you keep the profits and start the nonprofit as a totally separate and new entity.
- Form a board that will be the responsible and liable entity for the organization.

Does my state have an organization that provides services for nonprofits?

The National Council of Nonprofits, the nation’s largest nonprofit network, works through its member state associations to amplify the voices of America’s local community-based nonprofit organizations, help them engage in critical policy issues affecting the sector, manage and lead more effectively, collaborate and exchange solutions, and achieve greater impact in their communities.

Resource: The Nonprofit Board’s Role in Mission, Planning, and Evaluation

Ten Basic Responsibilities of Nonprofit Boards

1. **Determine mission and purposes, and advocate for them.** It is the board's responsibility to create and review a statement of mission and purpose that articulates the organization's goals, means, and primary constituents served and advocate for their organization by "standing for their mission" (www.standforyourmission.org).
2. **Select the chief executive.** Boards must reach consensus on the chief executive's responsibilities and undertake a careful search to find the most qualified individual for the position.
3. **Support and evaluate the chief executive.** The board should ensure that the chief executive has the moral and professional support he or she needs to further the goals of the organization.
4. **Ensure effective planning.** Boards must actively participate in an overall planning process and assist in implementing and monitoring the plan's goals.
5. **Monitor, and strengthen programs and services.** The board's responsibility is to determine which programs are consistent with the organization's mission and monitor their effectiveness.
6. **Ensure adequate financial resources.** One of the board's foremost responsibilities is to secure adequate resources for the organization to fulfill its mission by actively, consistently, and strategically advocating for the organization's mission.
7. **Protect assets and provide proper financial oversight.** The board must assist in developing the annual budget and ensuring that proper financial controls are in place.
8. **Build and sustain a competent board.** All boards have a responsibility to articulate prerequisites for candidates, orient new members, and periodically and comprehensively evaluate their own performance.
9. **Ensure legal and ethical integrity.** The board is ultimately responsible for adherence to legal standards and ethical norms.
10. **Enhance the organization's public standing.** The board should act as conscientious ambassadors who clearly articulate and advocate for the organization's mission, accomplishments, and goals to the public and garner support from the community.

Source: Richard T. Ingram, Ten Basic Responsibilities of Nonprofit Boards, Third Edition (BoardSource, 2015).

Legal Duties of Board Members

According to nonprofit corporation law, a board member must meet certain standards of conduct and attention to his or her responsibilities to the organization. These are referred to as the Duty of Obedience, the Duty of Care, and the Duty of Loyalty.

DUTY OF CARE means using your best judgment. It doesn't mean you have to be perfect or that you cannot make a mistake; just that you have exercised reasonable caution in making decisions.

DUTY OF LOYALTY means putting your personal and professional interests aside for the good of the organization. Having a conflict of interest policy in place would be one way to exercise duty of loyalty.

- **What is conflict of interest?**

When the personal or professional concerns of a board member or a staff member affect his or her ability to put the welfare of the organization before personal benefit, conflict of interest exists. Nonprofit board members are likely to be affiliated with many organizations in their communities, both on a professional and a personal basis, so it is not unusual for actual or potential conflict of interest to arise.

- **Why must we be concerned about conflict of interest?**

Board service in the nonprofit sector carries with it important ethical obligations. Nonprofits serve the broad public good, and when board members fail to exercise reasonable care in their oversight of the organization they are not living up to their public trust. In addition, board members have a legal responsibility to assure the prudent management of an organization's resources. In fact, they may be held liable for the organization's actions. A 1974 court decision known as the "Sibley Hospital case" set a precedent by confirming that board members can be held legally liable for conflict of interest because it constitutes a breach of their fiduciary responsibility.

- **Does conflict of interest only involve financial accountability?**

No. Conflict of interest relates broadly to ethical behavior, which includes not just legal issues but considerations in every aspect of governance. A recent statement by Independent Sector describes three levels of ethical behavior: (1) obeying the law; (2) decisions where the right action is clear, but one is tempted to take a different course; and (3) decisions that require a choice among competing options. The third level of behavior can pose especially difficult ethical dilemmas for nonprofit board members.

DUTY OF OBEDIENCE means being true to the organization's mission. A donor has a right to expect that funds given will be used for the stated purpose. It is also important that the board ensure that the organization is following all laws and regulations that may apply to nonprofits, such as payment of any taxes and public disclosure of information.

Adapted from Leifer, Jacqueline Covey and Michael B. Glomb, *The Legal Obligations of Nonprofit Boards* (BoardSource, Revised 1997)