

# Starting a Nonprofit 501(c)(3)

---

 [wagenmakerlaw.com/blog/starting-nonprofit-501c3](https://wagenmakerlaw.com/blog/starting-nonprofit-501c3)

August 25, 2020

Starting a Section 501(c)(3) nonprofit can be quite an adventure! What legal steps are required? While the details may vary widely, the concrete steps may be best summarized as follows: (1) form a nonprofit corporation, consistent with Section 501(c)(3) requirements; (2) apply to the IRS for recognition of tax-exempt status; and (3) understand and comply with applicable legal requirements for both state nonprofit status and federal tax-exempt classification. Vision is essential, and so is taking the right steps with the end goal in mind. The following guidance sets forth a roadmap for taking these steps, including numerous references to other Wagenmaker & Oberly blog articles providing additional guidance. Note that these steps apply equally well for other types of tax-exempt nonprofits, such as social clubs and trade associations, except with respect to tax deductibility of charitable contributions and other privileges accorded only to Section 501(c)(3) organizations.

## Part I – Corporate Development

---

### A. State Incorporation

---

First, the new organization should generally be incorporated. This is a matter of state law – to form a nonprofit entity under a specific state’s nonprofit law. By doing so the organization’s leaders can provide for corporate liability protection so that, generally speaking, only the corporation is responsible for the organization’s actions.<sup>[1]</sup> A nonprofit may remain unincorporated as an association of individuals, but that approach is not typically recommended given potential liability considerations and relatively minimal government involvement with corporate status.

Incorporation involves filing articles of incorporation or a similar charter document with a state agency (typically a Secretary of State’s office), containing the following core elements:

- Corporate name;<sup>[2]</sup>
- Corporate purpose;
- At least three directors;
- Identification of registered agent; and
- Dissolution language addressing disposition of assets upon the corporation’s end.

The directors should comprise key leaders to carry the initial vision, as founders who are both knowledgeable about and highly committed to organization’s anticipated activities.

Note that the purpose statement must include at least one Section 501(c)(3) tax-exempt purpose (i.e., charitable, religious, educational, scientific, etc.). More broadly, the corporate purpose statement serves as the organizational cornerstone for nonprofit and tax-exempt qualification, donor communications, and the board's fiduciary duty of obedience to the mission. The purpose statement thus should be carefully and thoughtfully developed, as a distilled, durable, and legally compliant articulation of the founders' vision.[4]

An additional question must be addressed: in what state should a nonprofit corporation be formed? All states generally have statutes that provide for the creation of a nonprofit corporation. Often the best choice is to incorporate where the hub of the organization will be located, where one or more of the key leaders are located, or where the primary activities will be conducted. Keep in mind that state nonprofit laws do vary in some very important and specific ways, so attentiveness to such state-specific requirements is critical. This could be as simple as a proper suffix to a corporate name. Indiana requires the use of "Inc." or "Corp." to end the corporate name. Illinois does not have such rules, but may require the use of NFP if the name is not patently philanthropic. Other state distinctions may be more legally significant by requiring membership, limiting who can serve on a board, or imposing other restrictions on a nonprofit's operations.

Upon proper incorporation, the organization should now be legally eligible to receive tax-deductible charitable contributions, provided that it applies for tax-exempt recognition with the IRS within 27 months of incorporation. But the nonprofit must correctly follow through with the IRS process! Note too that government agencies, private foundations, and other donors may require the actual IRS determination letter as a condition for giving funds.

## **B. Employer Identification Number**

---

Once the Articles of Incorporation (or similar charter document) is filed with the Secretary of State or state, then the organization is officially "born" as a legal entity. Consequently, just as a person gets a social security number, the new corporation needs to obtain a federal Employer Identification Number ("EIN" or "FEIN") by filing IRS Form SS-4 with the IRS. The form requires the organization's legal name, corporate address, contact information, incorporation state, corporate start date, basic tax-exempt purpose information, and the last month in the organization's fiscal year. If the organization will immediately have employees, then this information needs to be disclosed too.

A corporate director or officer must sign the form as the organization's "responsible party" for IRS tax purposes. This person must provide his or her social security number, as a one-time bridge to the FEIN. The form should be submitted electronically, for security

purposes and expediency. After Form SS-4 is submitted, the organization will receive an EIN Letter from the IRS.

This process should be quick – it only takes about 15 minutes to apply for an EIN online. Once this is complete, the nonprofit should have the proper documentation needed to open a bank account but should memorialize this corporate action in a resolution. Preferably, the nonprofit will also select officers, such as a President and/or Treasurer, identified as bank signatories (as addressed below regarding First Meeting Minutes).

## **C. Corporate Bylaws**

---

The next step is to develop corporate bylaws, which contain a nonprofit's internal governing rules. Viewing a nonprofit as a legal "person," as noted above, the bylaws effectively function as its "skeleton" - internally determining how the nonprofit corporation should "move" in its governance and key aspects of its operations.

For example, the bylaws should explain how a nonprofit's directors and officers are selected and removed, the scope of their authority, and whether others may participate in any governance or other activities (e.g., advisory councils and other committees). Other key bylaw provisions include meeting procedures, financial and signatory authority, conflict of interest procedures, and indemnification allowances for potential personal liability.

Just as a skeleton fits a specific person's body, so should bylaws be tailored for each nonprofit. Good bylaws thus fit an organization's particular goals for governance, smooth operations, and clarity. A church's membership bylaws may look far different, for example, than a social service provider's bylaws. Our law firm typically starts with form corporate bylaws, depending on the type of nonprofit, and then assists clients to customize the bylaws in light of certain desired corporate governance (particularly with respect to directors, officers, and members – if any) as well as applicable state law.

The bylaws can be thought of as a management manual for the organization's leadership, which (1) accurately fit the organization's actual governance and operations, (2) are internally consistent, (3) are legally compliant, and (4) are consistent with "best practices" considerations.

## **D. Conflict of Interest Policy and Other Policies**

---

A conflict of interest policy constitutes a core requirement for a new nonprofit. Such a policy is fundamental enough to include as an addendum to the bylaws. A conflict of interest policy defines prohibited transactions and recommends procedures for avoiding, resolving, or removing a potential conflict. For example, the policy should define what it means to be an "interested person," address self-dealing, describe what to do with

disclosures of conflicts of interest, address both financial and non-financial conflicts, and require a written annual disclosure statement from each director regarding such matters. Note too that the IRS and state regulators care about such matters, particularly to avoid abuse of charitable assets. Consequently, a conflict of interest policy and its usage should be compliant with such legal requirements.

Conflicts of interest are directly related to directors' fiduciary duty of loyalty, which requires that directors be "disinterested" and independent of one another. Disinterested directors are not *uninterested*, but rather they are interested in the organization's benefit rather than personal benefit. Conflicts of interest thus occur when a nonprofit director acts in a different capacity than as a disinterested, independent director, such that the director is no longer living up to the duty of loyalty.<sup>[5]</sup>

Other corporate policies may be appropriate during the start-up phase too. For example, the nonprofit may adopt a dispute resolution policy, requiring that internal disputes are settled through mediation or arbitration, as an alternative to or precondition to litigation. Such policy may be highly effective both as a risk management tool and to encourage leaders to participate diligently and actively in board deliberations. Other key policies may include grantmaking (e.g., for international organizations) or a faith statement (for religious organizations).

## **E. First Meeting Minutes**

---

Once the nonprofit is incorporated, the nonprofit's initial directors need to take their first official governing steps. Such steps may be accomplished through a meeting, at which the Board physically meets, or interacts through teleconference or videoconference. Alternatively, the Board may act through a unanimous written consent of all initial directors, such as through reply emails from each director approving a prescribed list of initial corporate actions. If the initial group of leaders is to change in any way from the list of directors set forth in the articles of incorporation, or if unanimity is not feasible, then a meeting must take place.

The prescribed list of initial corporate actions should include the following: (a) approval of the filed articles of incorporation; (b) approval of the bylaws; (c) any desired change in directors; (d) directors' initial terms (per the bylaws); (e) appointment of officers (also per the bylaws); (f) ratification for retention of legal counsel; (g) identification of the organization's bank and designation of certain officers as bank signatories; (h) authorization for developing and filing the IRS Form 1023 tax-exemption application; and (i) recognition of each director's completed and signed annual disclosure statement, addressing conflicts of interest consistent with the above-described corporate policy. Other matters to be addressed may include employment of an executive director or other employees, ratification of pre-incorporation contracts, transition from any prior financial arrangements, and adoption of additional corporate policies. All such matters should be

recorded in writing, as the nonprofit's initial corporate resolution.[6]

## **Part 2 - Applying for Recognition of Section 501(c)(3) Tax-Exempt Status**

---

To obtain IRS recognition of the nonprofit as a Section 501(c)(3) tax-exempt organization, an IRS Form 1023 application must be filed (or its self-certification Form 1023-EZ counterpart). Note, however, that churches, other houses of worship, their denominations, and their integrated auxiliaries are automatically tax-exempt. They thus need not file an IRS Form 1023 unless they wish to do so.

The IRS Form 1023 application is appropriate for most contexts in which a nonprofit seeks tax-exempt recognition. Typically it consists of the form itself, containing detailed questions, as well as certain required schedules (depending on specific activities – e.g., housing, schools), a supporting narrative, accompanying financial information, and attached corporate start-up documents. The heart of the Form 1023 application is the supporting narrative, because it describes the organization and the specific ways it meets the organizational and operational tests arising under Section 501(c)(3). The supporting narrative must explain the organization's past, present, and planned activities. More specifically, the supporting narrative must specify who conducts the activity, where the activity takes place, how much time and effort is devoted to the activity, how the activity is funded, and how it furthers the organization's tax-exempt purposes. Nonprofit should feel free to attach relevant policies, website excerpts, articles, pictures, and other materials to bolster the supporting narrative.

The IRS Form 1023 thus amounts to a business plan, setting forth the organization's program details, legal compliance, and capable leadership. All of this information is intended to help the IRS determine the key legal question: is the nonprofit both organized and operated in accordance with Section 501(c)(3) requirements, exclusively (i.e., primarily) for public benefit and not for any improper private benefit?[7]

The streamlined IRS Form 1023-EZ has its place too. It is cheaper overall, with a \$275 IRS filing fee instead of \$600 for the Form 1023 version, and involves less attorney time for preparation. In addition, the Form 1023-EZ has a quicker IRS turnaround time - about 1-2 months instead of the expected 4-6 months for the Form 1023. However, this self-certification approach is not without risk, since the individuals are certifying that they legally meet the requirements of 501(c)(3), which are significant, without the same disciplined rigor in evaluation and development for the full-blown IRS Form 1023 (which is probably why organizations using the Form 1023-EZ are reportedly at a higher risk in the event of an audit). Note too that many organizations are not eligible to use the Form 1023-EZ, such as organizations reasonably expecting to receive at least \$50,000 annually as well as houses of worship (if they choose to apply), and other specific types of organizations.

## Part Three – Additional Matters for Legal Compliance

---

Once the new nonprofit is established through its corporate development and IRS tax-exempt application, the leaders should consider the following additional areas for legal compliance.

The nonprofit corporation may owe annual or other periodic reports to the state Secretary of State (or comparable agency), and it must file IRS Form 990 annual reports.<sup>[8]</sup> Note that certain states require additional state “franchise” reports to confirm state tax exemption, such as in California and Texas.

Additionally, the nonprofit leaders should consider state-specific charitable solicitation registration (CSR) and related reporting requirements in connection with its fundraising activities. CSRs are required for each state in which a nonprofit is active, as triggered by the requisite “nexus” (i.e., sufficient contacts, such as if a nonprofit engages in fundraising from a state through its workers). A patchwork of state-specific regulatory requirements and enforcement mechanisms applies, generally as consumer protection measures with the state Attorney General offices acting to protect against unscrupulous fundraising. Most states require an initial CSR, but with varied threshold financial and charitable activity standards. Additionally, many states provide for religious, educational, or membership exemptions from CSRs, and some states do not require any CSRs. Questions about whether a nonprofit must file CSRs in multiple states thus may depend on both specific state law and the nonprofit’s activities.<sup>[9]</sup>

Nonprofits also should consider legal compliance requirements arising from operational aspects, such as whether employee contracts or other employment-related measures are warranted, facility usage considerations, the advisability of applying for state sales tax exemption for retail purchases,<sup>[10]</sup> whether sales tax liability may be owed for the nonprofit’s own sales,<sup>[11]</sup> how best to handle charitable receipting, and other tax-related issues.<sup>[12]</sup> Such matter may be best addressed as the nonprofit continues its journey onward of serving the public interest through its tax-exempt activities, all with attentive and capable leaders who are mindful of the numerous and varied legal compliance aspects too.

---

<sup>[1]</sup> Personal liability against a nonprofit corporation’s leader should arise only when the leader engages in gross negligence or willful misconduct, or when a law specifically provides for such personal liability (e.g., knowing misuse of payroll tax funds). For additional information, see our blogs [available here](#) and [also here](#).

<sup>[2]</sup> For additional considerations regarding selecting a corporate name, see [our blog here](#).

<sup>[3]</sup> The registered agent is the person or entity who will receive legal documents on behalf of the organization in the state, and the registered agent must have a physical address in

such state. For further guidance, see [our blog here](#).

[4] For further guidance on developing an effective corporate purpose statement see [our blog here](#). For further guidance about directors' fiduciary duty of obedience to the corporate purpose statement, [see here](#).

[5] For further guidance on conflicts of interest and the fiduciary duty of loyalty, [see here](#).

[6] For more information on corporate resolutions, [see here](#).

[7] For further guidance regarding these requirements, see our [April 6, 2017](#) blog; our [November 18, 2015](#) blog; and our [November 17, 2016](#) blog here.

[8] For more information about IRS Form 990 reporting requirements, [see here](#).

[9] For further guidance about state fundraising legal compliance, [see here](#).

[10] [See here](#) for more information.

[11] For guidance on this important legal compliance area, [see here](#).

[12] Note that while tax-exempt nonprofits are exempt from paying federal income taxes on their net revenues, they may nevertheless owe taxes on income generated from unrelated business activities. [See here](#).

---

CHICAGO, IL 53 W. Jackson Blvd, Suite 1734 Chicago, IL 60604 [312.626.1600](#)

CHARLESTON, SC 115 River Landing Dr, Suite 102 Charleston, SC 29492 [843.377.8969](#)

---



**Wagenmaker & Oberly**

*Trusted Advisors to Nonprofits*

wagenmakerlaw.com