

**FORMING A NEW NONPROFIT:
INITIAL CLIENT CONVERSATION, STEPS FOR FORMATION,
APPLYING FOR TAX-EXEMPT STATUS, AND
DUTIES AND LIABILITIES OF DIRECTORS AND OFFICERS
May 13, 2009**

I. Initial Client Conversation

A. *Nonprofit 101*

1. Tax-exempt status of nonprofits evolved out of an attempt by the government to promote certain activities deemed beneficial to society at large.
2. Status as a nonprofit does not mean the organization cannot earn a profit, so long as excess revenues over expenses are not paid out for the benefit of individuals. This is called the ban on private inurement.
3. Nonprofits may pay reasonable compensation for services performed or goods provided to the nonprofit.
4. Advantages of tax-exempt status include exemption from state and federal income taxes (except unrelated business income), as well as charitable income, estate and gift tax deductions for individuals donating to 501(c)(3) nonprofits (Internal Revenue Code (“IRC”) sections 170, 2055, and 2522).
5. Disadvantages of tax-exempt status include a complicated regulatory framework that must be complied with; including statutory limitations on compensation paid by the nonprofit to individuals and outside organizations, excise taxes under IRC 4958 on excess benefit transactions, a limitation on lobbying, and a prohibition on participation in political campaign activities. Note: there are even more onerous rules for nonprofits classified as a private foundation.
6. IRC section 501(c)(3) covers organizations organized and operated “exclusively” for specifically listed tax-exempt purposes, which include purposes that are charitable, educational, scientific, and religious. The IRC makes clear that operating exclusively has been interpreted as being *primarily engaged in* activities which accomplish one or more of the nonprofit’s exempt purposes.

B. Ask why the client wants to form the nonprofit

1. Have the client describe in detail (i) the work that they would like to do through the nonprofit, (ii) how they intend to support the nonprofit (i.e., where will the money be coming from?), and (iii) whether there are other nonprofit organizations they expect to work with or through to achieve their objectives.

C. Questions to ask yourself

1. Are the proposed purposes and activities of the nonprofit described in IRC section 501(c)(3) (i.e., charitable, educational, scientific or religious)?
2. Can these activities be conducted through an existing nonprofit or do they require the formation of a new nonprofit organization?
3. Does the client have the commitment, funding, and goals necessary to justify moving forward in forming a new nonprofit organization?
4. Will the nonprofit have significant unrelated business income that could jeopardize its tax-exempt status?
5. Would the client's purposes be suitable for or more sustainable as a for profit organization?

D. Discuss options with client

1. Unincorporated association (Chapter 184 of Wisconsin Statutes)
 - a) Advantages: Entity can be tax-exempt and accept tax deductible contributions. No required formalities for formation and few for operation. Wisconsin recognizes a distinction between an unincorporated association and its members, and provides limited liability protection for such organizations (Wis. Stat. Sec. 184.04). Chapter 184 of the Wisconsin Statutes allows for some structure and the legal ability for the association to own property and to sue and be sued. Most flexible nonprofit structure.
 - b) Disadvantages: Somewhat less liability protection than with corporations. Unlike corporations, no framework of rules to assist in organizing operations. Many individual donors and foundations prefer making grants or contributions to nonprofit corporations with a

determination letter from the IRS, so this structure may limit ability to raise funds.

c) Best structure for informal, small organizations with limited exposure to liability and fewer fundraising needs. Examples include neighborhood associations and small theater groups.

2. Nonstock corporation (Chapter 181 of Wisconsin Statutes)

a) Advantages: Entity can be tax-exempt *and* accept tax deductible contributions. Preferred structure for recipients of foundation grants. Clear statutory rules and ample case law guide activities and operations. Specific legal authority when disputes arise. Some liability protection for individuals involved, as corporations are generally liable for the debts and obligations of the organization. Easier to make changes to nonprofit corporations than nonprofit trusts.

b) Disadvantages: Complex formational and operational requirements, including the need to keep records and have certain governance documents.

c) Default best option. Best structure for nonprofits with day-to-day activities.

3. Trust (Chapter 701 of Wisconsin Statutes)

a) Advantages: Can be tax-exempt *and* accept tax deductible contributions. Fewer rules apply to trusts than corporations, so they are somewhat easier to administer because there are fewer mandated formalities (such as meeting minutes) and reporting requirements. As trusts are generally harder to amend (generally must obtain court approval), they are a better organizational form for donors interested in preserving their interests and ideas in perpetuity.

b) Disadvantages: Rules applicable to trusts are generally less clear and detailed than those that apply to corporations. Because operational rules are less detailed, they are generally less practical for operating nonprofits with day-to-day activities. Trusts are generally supervised by the courts, which means it can require more time and expense to amend the trust or to resolve disputes.

- c) This structure is generally appropriate only for a nonprofit that primarily collects, invests, and distributes funds or other property (i.e., a private foundation).
4. For profit corporation (Chapter 180 of Wisconsin Statutes)
- a) **Advantages:** Clear statutory rules and case law to follow. Need not spend time and money on process for obtaining and maintaining tax-exempt status. No taxes will be due if no profit earned. Strict compensation restrictions for nonprofits would not apply. Like nonprofit corporations, some liability protection for individuals involved as corporations are generally liable for the debts and obligations of the organization.
 - b) **Disadvantages:** Cannot accept tax-deductible contributions and not tax exempt. This could severely restrict fundraising options. Taxes on profits (i.e., excess of revenue over expenses). Unlike nonprofits, no federal or state statutory protections for volunteers.
 - c) This structure may be best for organizations whose activities may be similar to other for profit businesses and who do not need to rely on tax-deductible contributions from individuals or grants from foundations. Examples include an environmental consulting company or a hospital. Many organizations that support themselves via a fee-for-services or the sale of products can operate comfortably as a for profit.
5. Donor advised fund (often in a community foundation, such as the Greater Milwaukee Foundation) (IRC section 4966)
- a) **Definition:** Separately identified fund which is held by a public charity over which the donor can suggest distributions. A donor advised fund provides many of the benefits of a private foundation without the legal complications and expense of setting up and operating a private foundation, as well as ongoing administrative responsibilities and expenses.
 - b) **Advantages:** Tax benefits of public charity status (higher percentage of income deductible for donors, no tax on net investment income, no private foundation excise taxes) while generally operating like

a private foundation. No need for IRS Form 1023 exemption application, annual tax filings, managing finances, etc.

c) Disadvantages: Donors have less control than they would with a private foundation. Gifts must be within exempt purposes of charity holding the fund. Often, a small annual fee is paid to the charity holding the fund for maintenance of the fund (often 1-2% of assets).

d) This structure is generally best for individuals or families that would like to make grants to existing nonprofits but do not want to donate sufficient funds into a private foundation to justify the expense and additional responsibilities. A donor advised fund also may be appropriate for individuals who are not interested in taking meeting minutes, completing annual tax filings and investing funds of a family private foundation. This type of organization is not appropriate for those who want the nonprofit to conduct day-to-day activities, such as operation of a food bank or teaching low-income children how to swim.

6. Fiscal sponsorship

a) Definition: Contractual relationship between organization and an existing nonprofit. Through this contractual relationship, the existing nonprofit accepts and manages funds for the organization and the organization conducts activities that are consistent with the existing nonprofit's exempt purposes. The organization essentially becomes a program under the existing nonprofit and derives the ability to accept tax-deductible contributions via this relationship

b) Advantages: Most of the benefits of a nonprofit corporation with fewer start-up and ongoing responsibilities. Can accept tax-deductible contributions via existing nonprofit. Like nonprofit corporations, no taxes other than unrelated business income tax. Enhanced credibility and prestige via affiliation with existing nonprofit.

c) Disadvantages: Possible loss of autonomy. Obligations to existing nonprofit, including periodic reports. Must act within exempt purposes of existing nonprofit. Generally, fees of 5 to 15% of gross receipts to existing nonprofit. Conduit arrangements are strictly prohibited. Thus, control over funds is lost by the organization as the existing nonprofit must, by law, have complete discretion and control over the funds.

d) This structure may be best for new nonprofits that are still deciding what they would like to do and where their supporting funds will come from, or for nonprofits who would rather focus on their direct charitable activities and don't care deeply about being independent from other organizations. See www.fiscalsponsorship.com for more information and model documents.

E. To help with the decision-making process, describe to the client the initial as well as ongoing responsibilities of forming and operating a Wisconsin nonprofit corporation.

1. Impress upon the client that forming a nonprofit requires up front as well as ongoing time, work and expenses.
2. Formation process (outlined in greater detail later in this presentation) – drafting and filing articles of incorporation, bylaws, and IRS Form 1023 application with attendant filing fees of up to \$800.
3. Annual IRS filing
 - a) Generally, nonprofit organizations are required to file an annual information return with the IRS. Note that the requirements for organizations filing each of these forms change over the next few years due to a phase in of requirements for the newly-revised Form 990.
 - b) Form 990 – for largest organizations classified as public charities
 - c) Form 990-PF – for organizations classified as private foundations
 - d) Form 990-EZ – for mid-sized organizations classified as public charities
 - e) Form 990-N – for the smallest organizations classified as public charities
4. Wisconsin annual report
 - a) All Wisconsin nonprofits must file an annual report with the Wisconsin Department of Regulation and Licensing. The report will be mailed by the State to the organization's registered agent. A Wisconsin nonprofit that receives more than \$5,000 in a year must file an annual report (generally Wisconsin Form 308) setting forth its financial

operations for the year. Nonprofits receiving \$5,000 or less in a year or nonprofits operating solely in one community and raising less than \$50,000 must file Wisconsin Form 1943 Affidavit in Lieu of Annual Financial Report. See <http://drl.wi.gov/dept/forms/fm285.pdf> for more information.

b) These forms must be filed with the Wisconsin Department of Regulation and Licensing within six months of the end of the organization's fiscal year (July 1st for calendar year organizations). Note: additional financial review requirements apply to organizations receiving contributions of over \$200,000 (review by independent CPA) or \$400,000 (audited financial statements) during the fiscal year.

5. Form 990-T and Wisconsin Form 4-T (when \$1,000 or more of unrelated business taxable income).

6. Registration to solicit funds in Wisconsin (and other states where fundraising is conducted).

a) If any fundraising is conducted in Wisconsin, file Wisconsin Department of Regulation and Licensing Form 296 by August 1st of each year with \$15 fee.

b) Solicitation in Wisconsin is governed by Wisconsin Statutes Chapter 440.41 thru 440.48.

7. Sales tax exemption

a) An organization that would generally be tax-exempt under IRC section 501(c)(3) should qualify for exemption from Wisconsin sales tax. A Wisconsin nonprofit organization must apply to the Wisconsin Department of Revenue for a Wisconsin Certificate of Exempt Status number by filling out the Application for Wisconsin Sales and Use Tax Certificate of Exempt Status (Form S-103) at <http://www.dor.state.wi.us/forms/sales/s-103.pdf>. This number will allow the nonprofit to avoid paying sales tax when it makes purchases.

8. Disclosure obligations

a) The nonprofit will be subject to various federal disclosure obligations.

b) For example, the nonprofit must make its annual IRS filing (IRS Form 990) for the last three years and its application for tax-exempt status (IRS Form 1023) available for public inspection without charge at its principal office during regular business hours. The nonprofit also must make provide a copy of such documents without charge (other than a reasonable fee for reproduction and actual postage costs) to any individual who makes a request.

9. Seller's permit

a) If the nonprofit sells taxable items, it may need to obtain a Wisconsin seller's permit and collect sales tax. The nonprofit must file sales tax returns if sales tax is due. Occasional exemptions will apply.

10. Books and records

a) The nonprofit must maintain complete and accurate books and records. Such books and records must contain the information necessary to prepare the nonprofit's tax returns and other annual reports.

11. Employment taxes

a) If the nonprofit has employees, it must file employment tax returns, withhold taxes, pay FICA tax and state and federal unemployment taxes, and obtain worker's compensation insurance.

12. Substantiation of gifts

a) Upon receipt of any gift with a value of \$250 or more, the nonprofit must provide the donor with a receipt indicating (i) the property received (if not cash), (ii) the date it was received, and (iii) whether the donor received any goods or services in return (not including certain *de minimus* gifts).

b) If a donor makes a gift of more than \$75 and receives goods or services in return, the nonprofit must prepare a receipt indicating the property donated and the fair market value (not cost) of the goods or services received.

c) In addition, due to more stringent documentation requirements recently imposed on charitable tax deduction claims, some donors may ask

for statements to substantiate smaller donations. Many nonprofits prepare statements for **all** donors regardless of the value of the item or amount donated to assist their donors in claiming a charitable income tax deduction. This, of course, can be quite time consuming.

F. Pro Bono Project Approval

1. If you practice at a firm and wish to represent the nonprofit on a pro bono basis, take the steps necessary for firm approval of the project as a pro bono project. Be sure to define the project as the formation and qualification of new nonprofit. Be wary of committing to act as general counsel of the nonprofit on a pro bono basis.
2. Ask the nonprofit if it is willing to bear the attendant costs (between \$300 and \$800 for state and federal filings).

II. Steps for Formation of a New Nonprofit

A. Incorporation

1. First formal step in the formation of a nonprofit corporation is the filing of the Articles of Incorporation with the Wisconsin Department of Financial Institutions. Model Articles of Incorporation for a Wisconsin nonprofit corporation can be obtained on the Department of Financial Institution's website (http://www.wdfi.org/resources/indexed/site/corporations/form102_f.pdf) or via M-LINC.
2. Note: Use the Department of Financial Institutions' model Articles of Incorporation for nonstock corporations with caution, because they do not contain information required by the Internal Revenue Service for 501(c)(3) (i.e., tax-exempt) status. Specifically, the IRS requires:
 - a) Language limiting the nonprofit's purposes to those exempt under IRC Section 501(c)(3).
 - b) Language specifying that, upon dissolution, all of the nonprofit's assets will be distributed for the nonprofit's exempt purposes or to another nonprofit organization engaged in similar activities. This language is required to uphold the ban on private inurement.

c) Language noting that the nonprofit is organized and operated exclusively for charitable, educational, scientific or religious purposes described in IRC Section 501(c)(3)....

3. Chapter 181 of the Wisconsin Statutes governs nonstock corporations, and Section 181.0202(1) lists required information for such organization's articles of incorporation.

4. Corporate name. The corporation's name must include one of the following words or abbreviations: Corporation, Corp., Incorporated, Inc., Company, Co., Limited, or Ltd. The name also must be distinct from other names of corporations authorized to transact business in Wisconsin. Confirm the availability of the name in advance with the Wisconsin Department of Financial Institutions. Consider also looking into trademark availability and website domain availability before filing the articles of incorporation.

5. Members. A Wisconsin nonprofit corporation may have both members and a board of directors or only a board of directors. Please note that there is a distinction between legal members and "members" of a nonprofit, such as the Milwaukee Art Museum. Most nonprofit corporations should not have legal members as they generally complicate operations. Only create an entity with members if there is a compelling reason to do so. If the corporation has members, the members are usually given the right to vote on such matters as the election of directors, amendment of the articles of incorporation and bylaws, and dissolution of the corporation. However, the articles and bylaws may restrict or eliminate the members' voting rights.

6. Corporate purpose. The statement of the corporation's purposes in the articles should be drafted broadly so that they encompass all current, future and potential activities of the nonprofit. The language, as referenced above, also must fall within the parameters of IRC Section 501(c)(3).

7. Directors. All corporations have directors. Directors control the corporation and are elected in the manner set forth in the bylaws. Generally, new directors are elected by the current directors. However, it is possible for the articles and bylaws to specify that one or more directors will be appointed by an outside authority (perhaps a related organization).

8. Officers. Most nonprofit corporations have the following officers: President, Vice President, Secretary and Treasurer. The officers are elected by

the board of directors to carry out the day-to-day business of the nonprofit. One individual may serve as both an officer and a director at the same time.

9. Keep articles to a minimum. As a change in the articles of incorporation requires filing an amendment with the Department of Financial Institutions, it is generally advisable to include only statutorily required provisions. Other provisions can be inserted in the nonprofit's bylaws and other organizational documents such as governance policies.

B. Bylaws

1. Bylaws are the body of internal rules and procedures adopted by the nonprofit's board of directors and, if applicable, its members for the management of the nonprofit. Generally, the bylaws contain provisions relating to the election of directors and officers, the conduct of the nonprofit's affairs, the powers of its members (if any), directors and officers, conflict of interest policies and indemnification of officers and directors. Note: this document is not filed with the State of Wisconsin.

2. Generally, Chapter 181 of the Wisconsin Statutes provides default rules for items not made clear by the corporation's bylaws.

3. Note: Chapter 181 does impose certain requirements on Wisconsin nonprofit corporations, such as having a minimum of three directors (Wis. Stat. Sec. 181.0803).

4. Provisions to focus on:

a) Directors in general. The bylaws should specify the number (preferably a range between 3 and 15 for most organizations), the qualifications, and the manner of appointing or electing directors.

b) Director terms. Unless the bylaws specify otherwise, directors serve for a term of one year (Wis. Stat. Sec. 181.0805(1)). Most bylaws should specify a term of one, two or three years. Consider also bylaws that stagger the terms of directors so that in any given year only a minority of the directors have their term end. This allows for greater maintenance of institutional knowledge and continuity.

c) Director compensation. The Wisconsin statutes do not prescribe limits on the compensation of nonprofit directors. Nevertheless, most

nonprofits do not compensate their directors other than reimbursing expenses relating to their service as directors. It is generally advisable that nonprofits not compensate their directors other than expense reimbursement. Remember that the Internal Revenue Code ban on private inurement ultimately limits the amount of compensation that can be paid to nonprofit directors, officers, employees, and others.

d) Action without a meeting. The Wisconsin Statutes (Section 181.0821) allow for nonprofit directors to act without a meeting by signing a written document. The organization's bylaws should also explicitly provide for this ability. Such signatures can be electronic under the Wisconsin Statutes.

e) Meetings via teleconference. The Wisconsin Statutes (Section 181.0820) allow for nonprofit director meetings to take place via a teleconference where all attendees can hear each other. The organization's bylaws should also explicitly provide for this ability.

f) Amendment of bylaws. Wisconsin Statutes Section 181.1020 provides guidelines for the amendment of the corporation's bylaws, including the timeframe and content of proper notice for a meeting in which an amendment of the bylaws will be considered. At least a majority of all directors must vote to approve the amendment of the bylaws.

5. Model bylaws for a Wisconsin nonprofit corporation can be obtained via M-LINC.

C. Initial meeting

1. After the articles of incorporation have been filed with the Department of Financial Institutions, an initial meeting of the nonprofit's directors must be held.
2. Business that should be undertaken at this initial meeting includes adoption of the bylaws, ratifying the actions of the incorporator, election of officers, authorization of an officer to open bank accounts on behalf of the nonprofit, authorization of the necessary state and federal filings, such as the IRS Form 1023.
3. Other business of the nonprofit may be undertaken at the organizational meeting.
4. Model minutes for the organizational meeting can be obtained via M-LINC.
5. Any action permitted to be taken at the initial meeting of the board of directors may be taken without a meeting if each director signs a document detailing the actions so taken. A model unanimous written consent in lieu of the initial meeting can be obtained via M-LINC.

D. Obtain employer identification number via IRS Form SS-4

E. File IRS Form 1023 to obtain tax-exempt status