

FORMING A NEW NONPROFIT
INITIAL CLIENT CONVERSATION, STEPS FOR FORMATION, INTRODUCTION TO
TAX EXEMPT STATUS AND LIABILITIES OF DIRECTORS AND OFFICERS

May 13, 2009

III. Introduction to Tax Exempt Status

A. *Distinction between Non-profit and Tax-exempt*

The term Non-profit means that an organization is incorporated under the State's non-profit corporation statutes as opposed to a for-profit corporation. A non-profit organization does not issue stock or have shareholders. No person owns the organization and, generally, there is a prohibition against private inurement or benefit to individuals involved with the entity. However, this does not mean the entity is tax-exempt. Tax-exempt status is provided for in the Internal Revenue Code (IRC) and granted by the Internal Revenue Service (IRS) upon approving an entity's application for such status.

B. *Advantages and Benefits of Tax Exempt Status*

1. The primary advantage of tax exemption is that the entity does not have to pay taxes on its income derived from tax exempt activities. It is required to pay taxes on income it derives from an unrelated trade or business.
2. Pursuant to IRC § 170 (c), contributions to organization described in IRC § 501(c)(3) are deductible by the donors (individuals, corporations, foundations).
3. Similarly, federal estate tax and gift tax deductions are available for donations to § 501(c)(3) organizations under certain circumstances.
4. Pursuant to IRC § 3306 (a) there is a Federal Unemployment Tax Act (FUTA) exclusion for employment services provided to § 501 (c)(3) organizations.
5. Certain benefits may be provided by tax exempt organizations to their employees, including tax-deferred annuities (IRC § 403 (b)) and deferred compensation (IRC § 457).

C. *Disadvantages of Tax Exempt Status*

Disadvantages of tax-exempt status include compliance with stringent operating requirements, subject to excise tax on certain excess benefit transactions, rule against private inurement, prohibition from engaging in partisan political campaign activities and limitation on lobbying activities.

D. Understanding Rationale for Tax Exemption

Concept of tax exempt status reflects that Congress has recognized the benefits to society of activities conducted by non-profit organizations and statutory scheme is designed to encourage such activities. Generally, the exemptions are designed to benefit society at large by serving or providing a significant Apublic benefit.@

E. Applying for Tax-Exempt Status

1. Internal Revenue Code Statutory Exemptions

There are a number of general exemptions available under the IRC Section 501(c), as follows:

- (a). ' 501(c)(1) - corporations organized under Acts of Congress
- (b). ' 501 (c)(2) - certain holding companies
- (c). ' 501 (c)(3) - charitable organizations
- (d). ' 501 (c)(4) - social welfare organizations
- (e). ' 501 (c)(5) - labor, agricultural or horticultural organizations
- (f). ' 501 (c)(6) - business leagues, chambers of commerce and similar organizations
- (g). ' 501 (c)(7) - social clubs and recreational organizations
- (h). ' 501 (c)(8) - fraternal benefit societies and orders
- (i). ' 501 (c)(9) - voluntary employees= benefit associations
- (j). ' 501 (c)(10) - domestic fraternal lodges
- (k). ' 501 (c)(11) - teachers= retirement fund associations
- (l). ' 501 (c)(12) - local life insurance associations, telephone associations, etc.
- (m). ' 501 (c)(13) - cemetery companies
- (n). ' 501 (c)(14) - credit unions and mutual associations
- (o). ' 501 (c)(15) - certain small insurance companies
- (p). ' 501 (c)(16) - crop financing companies
- (q). ' 501 (c)(17) - supplemental unemployment compensation trusts
- (r). ' 501 (c)(18) - employee funded pension trusts
- (s). ' 501 (c)(19) - organizations of members of the Armed Forces posts
- (t). ' 501 (c)(20) - group legal service plans
- (u). ' 501 (c)(21) - black lung liability trusts
- (v). ' 501 (c)(22) - ERISA trust plans
- (w). ' 501 (c)(23) - armed forces organization (organized before 1880)
- (x). ' 501 (c)(24) - ERISA trusts
- (y). ' 501 (c)(25) - certain real property holding companies
- (z). ' 501 (c)(26) - state established medical insurance organizations and HMO=s
- (aa). ' 501 (c)(27) - state established workers= compensation

organizations

(bb). ' 501(c)(28) - National Railroad Retirement Investment Trust

2. Qualifying for Section 501 (c)(3) Status

The majority of tax-exempt organizations are exempt under IRC ' 501(c)(3). In order to qualify for ' 501(c)(3) status, an organization must be both Aorganized@ and Aoperated@ exclusively for one of the following exempt purposes:

- (a). Religious
- (b). Charitable
- (c). Scientific
- (d). Testing for public safety
- (e). Literary
- (f). International amateur sports competition
- (g). Prevention of cruelty to children or animals

Organizational Test - The organizational documents (articles of incorporation and by-laws) must specifically limit the purposes to one or more exempt purposes under ' 501 (c)(3); the organization may not engage in activities that are not in furtherance of exempt purposes; and the articles must contain a provision prescribing that upon dissolution, the organizations assets must be distributed for exempt purposes within the meaning of ' 501 (c)(3).

Operational Test - The organization must primarily engage in programs and activities that reflect and further its exempt purpose and no more than an insubstantial part of its activities may be devoted to non-exempt purposes. No part of the earnings may inure to the benefit of individuals. Section 501(c)(3) organizations are restricted in how much political and legislative (lobbying) activities they may conduct and may not be an Aaction organization,@ i.e., it may not attempt to influence legislation as a substantial part of its activities and it may not participate in any campaign activity for or against political candidates. Treasury Regulations ' 1.501(c)(3)-1(c). If the organization engages in an excess benefit transaction with a person having substantial influence over the organization, an excise tax may be imposed on the person and any organization managers agreeing to the transaction.

3. Purpose of Section 501 (c)(4) Status

Another often used exemption is IRC ' 501 (c)(4). This exemption is available for organizations operated exclusively for the promotion of social welfare, local associations of employees the membership of which is limited to a designated company or persons in a particular municipality or neighborhood and the net earnings of which are exclusively for charitable, educational or recreational purposes.

This exemption is very similar to ' 501 (c)(3), but a primary difference is that contributions to ' 501 (c)(4) organizations are not deductible for federal income tax purposes. Therefore, if it is anticipated that the organization will rely on contributions from the general public, then it clearly should apply for ' 501 (c)(3) status rather than ' 501 (c)(4) status.

Additional characteristics that set these organizations apart from 501(c)(3) organizations include the unrestricted ability to lobby for legislation to further its exempt purpose as its primary activity. However, a section 501 (c)(4) social welfare organization may not participate in political campaigns on behalf of or in opposition to any candidate for public office, though it may engage in some political activities - so long as that is not its primary activity.

F. The Application Process

1. Generally, to be considered exempt from federal taxation under ' 501(c)(3), an organization must apply to the IRS for recognition as an exempt organization. IRC ' 508 (a). The application is submitted on Form 1023, Application for Recognition of Exemption Under 501 (c)(3) of the Internal Revenue Code.

2. Form 1023 is an application packet containing the application and detailed instructions. It consists of eleven sections, as follows:

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| Part I. | Identification of Applicant |
| Part II. | Organizational Structure |
| Part III. | Required Provisions in Your Organizing Documents |
| Part IV. | Narrative description of Your Activities |
| Part V. | Compensation and Other Financial Arrangements With Your Officers, Directors, Trustees, Employees, and Independent Contractors |
| Part VI. | Your Members and Other Individuals and Organizations That Receive Benefits From You |
| Part VII. | Your History |
| Part VIII. | Your Specific Activities |
| Part IX. | Financial Data |
| Part X. | Public Charity Status |
| Part XI. | User Fee Information |

3. A copy of the organizations Articles of Incorporation and by-laws must be submitted with Form 1023. As stated above, the articles must contain a clause providing that upon dissolution the corporation=s assets must be distributed for an exempt purpose. Form 1023 Part III 2(a).

4. The application requires the organization to include a detailed statement of its proposed activities. Form 1023 Part VIII

5. The current application requires the organization to submit a statement of revenues and expenses for the current year and for the past three years (in the case of an organization that has been in existence for four or more years) or a three years projected revenues and expenses (in the case of newly formed organizations). Form 1023 Part IX. However, this section of the application is currently under revision, and an applicant should refer to IRS Notice 1382 (see number 11, below).

6. The application must be filed within 15 months from the end of the month in which the organization was organized (incorporated). If Form 1023 is filed within that period, 501 (c)(3) status, if granted, will be retroactive to the date of incorporation. Treas. Regs. ' 1.5080-01(a)(s)(i). An organization may obtain an automatic 12-month extension to file resulting in 27 months to file. If an organization does not file within 27 months of the date of its organization, tax-exempt status, if granted, will not be retroactive.

7. There is a filing fee that must be submitted to IRS along with Form 1023. The fee is \$750.00 for organizations that expect revenues to exceed \$10,000.00 per year and \$300.00 for organizations that expect revenues not to exceed \$10,000.00 per year.

8. After receiving the application, the IRS may contact the applicant to seek clarification or additional information in connection with the review and processing of the application. The time period for processing the application may vary, depending, among other things, upon the specifics of the application and the workload at the IRS. Usually, IRS processing time is between three and six months. Upon approving the application, the IRS issues a Determination Letter stating that the organization has been recognized to be exempt under ' 501 (c)(3). The exempt status is subject to the organization's future operations being found to be in compliance with the exempt status.

9. Certain organizations are not required to file Form 1023 to be considered 501(c)(3) organizations, including churches and organizations that are not private foundations with gross receipts of not more than \$5000.

10. Often, donors and funding sources are not comfortable providing funds to an organization in the absence of a Determination Letter (which confirms the deductibility of the grant, contribution or donation. Occasionally, a donor will provide resources based upon a pending application with a view that tax exempt status will be forthcoming and retroactive.

11. There was an earlier version of Form 1023 that was revised in October 1994. The most recent revision was in June 2006. Currently, Form 1023 is in the process of being revised to reflect changes necessary to comply with certain new regulations that eliminate the advance ruling period. So, when applying, refer to IRS Notice

1382 (January 2009). It states that until Form 1023 is revised with respect to Parts IX (Financial Data) and X (Public Charity Status), the applicant must follow directives on Notice 1382.

12. Form 1024 is the application for exempt status under certain sections other than 501 (c)(3), including section 501 (c)(4), 501 (c)(5) and 501 (c)(6). It is important to determine which status is being applied for and to use the correct application.

IV. Duties, Responsibilities and Liabilities of Officers and Directors

A. *Role and Duties of Board of Directors*

1. The role of the Board of Directors is to make policy decisions and to govern the affairs of the organization in accordance with the applicable law and the organization=s articles of incorporation and by-laws.

2. The role of setting policy and providing oversight is distinguished from the function of managing the day-to-day operations which is not the role of the board. The day-to-day operations are generally the purview of the organization=s staff (CEO, Executive Director or others). In many smaller or less formal non-profits that do not have staff, individual board members (or the board as a whole) may also perform the activities of day-to-day management.

3. Directors appoint the officers of the corporation, including the president, vice-president, secretary and treasurer. In more formally structured organizations (particularly those with staff), the officers are officers of the board and, as stated above, this may be separate from functioning as an officer of the organization. In less formal organizations, the duties may be merged.

4. Often, boards of directors establish committees to oversee various functions and to carry out board duties. Typically, these may include an Executive Committee, Finance Committee, Development Committee, Program Committee (depending upon the organization=s activities) and an Audit Committee, along with any other committees deemed necessary or appropriate.

5. Directors of non-profit corporations are generally responsible for ensuring that sufficient resources are made available for the organization to carry out its mission. This may vary from case to case. It may range from overseeing fund-raising activities of staff to direct involvement in soliciting donations and making contributions.

B. *Rights and Responsibilities of Directors*

1. Non-profit directors have the right to have access to staff and management

and to inspect the corporations books and records at reasonable times and under reasonable circumstances, including financial records. Directors also have a right to receive notice of board and committee meetings and to participate in such meetings. A director is entitled to receive copies of meeting minutes as well as board and committee reports.

2. Directors and officers of non-profits are required to act in the interest of the organization in accordance with its stated mission and purpose. They are expected to act in a manner that is reasonable and informed and to exercise independent judgment when making decisions. Directors and officers are required to act consistent with a duty of care with respect to their role and function. The duty of care includes, but is not limited to the following:

- (a). To be informed of the corporation=s affairs
- (b). To attend meetings
- (c). To act in good faith
- (d). To exercise independent judgment
- (e). To maintain confidentiality and loyalty
- (f). To avoid conflicts of interest and self-dealing

C. Role and Duties of Officers

1. As stated at A. 3, above, in larger, more formal organizations (particularly those with separate staff), the officers are officers of the board of directors and the staff actually Arun@ the operation. In many smaller non-profits the roles of the board of directors and officers are merged and the directors are the Ade facto@ staff.

2. The officers are typically as follows:

President - responsible for calling and conducting meetings of the board, appointing committees, assigning duties, ensuring board oversight of the policies and activities of the organization.

Vice-President - acts in absence of president, often chairs important committees and performs other duties assigned by president or board of directors.

Secretary - responsible for keeping minutes of meetings of board of directors and other corporate records, sending meeting notices and agendas, and filing required reports with state or other regulatory agencies.

Treasurer - responsible for check book, bank account, financial records and documents, and for providing periodic accurate financial reports (usually monthly or at each meeting).

3. In organizations with staff, often some of the duties (particularly the record-keeping duties of the secretary and the bookkeeping and accounting duties of the treasurer) are performed by staff. In those instances, the board of directors continue to have oversight responsibilities.

4. At many non-profit organizations, the Chief Executive Officer position is referred to as the Executive Director (sometimes President or CEO). Organizations establish such other staff positions as necessary.

D. Director and Officer Liability

1. The Business Judgment Rule - With respect to non-profit corporations, liability arising from actions of the organization will generally rest with the organization and not with individual officers or directors. Where the director or officer has acted in good-faith and in a manner believed to be in the best interest of the corporation consistent with the duty of due care, the director or officer is generally protected from personal liability. This rule, known as the Business Judgment Rule, generally will not apply where there has been a breach of fiduciary duty by the officer or director or misconduct such as fraud, self-dealing, criminal conduct or willful misconduct. ' 181.0855 Wisconsin Statutes

2. Measures to reduce exposure - Non-profit directors can take measures to reduce or avoid potential exposure to liability including implementing procedures, monitoring and reporting to identify and address potential problem areas. Non-profit officers and directors should also require financial audits, in most cases on a yearly basis.

3. Often, non-profit corporations provide directors and officers liability insurance coverage as a protection against claims resulting from their actions on behalf of the organization.

4. Under Wisconsin law, non-profit corporations may indemnify officers and directors against claims of personnel liability. The Wisconsin statutes contain provision that describe circumstances where indemnification is mandatory, where it may be limited and where it is not available. ' ' 181.0872, 181.0871(1) and 181.0877 (1), Wis. Stats.

E. Recent Enhanced Scrutiny of Governance of Non-Profit Organizations

1. Congress and the IRS have recently focused on enhanced scrutiny and governance of tax-exempt organizations. The IRS has revised Form 990 (exempt organization tax return) to contain new disclosure requirements, including, for instance, whether the organization has policies pertaining to board independence and conflicts of interest. A law recently enacted by Congress, known as Sarbanes-Oxley, was drafted to apply to publicly traded companies as opposed to tax-exempt

organizations, however, it has impacted the new requirements in the Form 1023 and Form 990 that generally seek greater transparency and accountability.

2. Sarbanes-Oxley guidelines for role of audit committee are emphasized and underscored. Many organizations that did not previously have an audit committee are establishing such committees and providing training concerning governance matters.

3. In addition, the IRS recently published a document entitled A Good Governance Practices for 501 (c)(3) Organizations.[@] This document recommends that 501 (c)(3) organizations implement several specific practices to promote good governance and to enhance legal and regulatory compliance. The document makes recommendations pertaining to tax-exempt organizations that address the following areas: (1) Statement of purpose; (2) Code of Ethics and Whistle Blower Policies; (3) Duty of Care; (4) Duty of Loyalty; (5) Transparency; (6) Fundraising; (7) Stewardship; (8) Compensation decisions; (9) Document retention policy. The IRS has indicated that its decisions to conduct a review of the operations of tax-exempt organizations will be influenced by whether an organization has adopted such practices.