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THE FORMATION AND QUALIFICATION OF A NONPROFIT ORGANIZATION¹

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¹This document is not exhaustive or all-inclusive and is intended for general guidance only. For more information, please consult qualified legal counsel.



THE FORMATION AND QUALIFICATION OF A NOT-FOR-PROFIT CORPORATION

This guide outlines the steps and anticipated timing, as well as certain filing fees, associated with the formation and qualification for tax-exemption under section 501(c)(3) of the Internal Revenue Code (the “Code”) of a new not-for-profit corporation in the United States (the “corporation”).

1. The Incorporation Process.

A. Reservation of the Corporation’s Name (Optional).

A corporation may reserve the name it intends to use by filing an Application for Reservation of Name with the Secretary of State of the state in which it plans to incorporate (and paying an applicable fee – currently \$10 in New York and \$75 in Delaware). In New York, the filing will reserve a name for 60 days and may be extended twice (each time for an additional 60 days) upon written request to the Department of State and payment of an additional fee. In Delaware, the filing will reserve a name for 120 days and may be renewed for successive 120 day periods upon the submission of an additional filing to the Secretary of State and payment of an additional fee.

The reservation allows the corporation to hold the name it desires to use while it gathers the information necessary to incorporate. A copy of the name reservation filing must be submitted by the corporation with its incorporation document to establish that it is the entity that reserved the name.

The corporation’s name generally must include a corporate indicator, i.e., one of the words “corporation,” “incorporated” or “limited,” or an abbreviation thereof, with the following exceptions:

- Delaware allows any of the words “Fund,” “Foundation” or “Society” to be used as a corporate indicator.
- New York does not require a corporate indicator for corporations formed exclusively for “charitable” purposes. New York law does not define what is



considered to be “charitable” purposes and the New York Department of State interprets the term very narrowly. Thus, even if the corporation does not need a corporate indicator in its name to incorporate in Delaware, it may need to add one to its name to qualify to conduct business in New York.

B. Incorporation.

The first formal step in the formation of a corporation is the filing of a Certificate of Incorporation (which may also be referred to as “Articles of Incorporation,” “Articles of Association” or a “Charter,” depending on the state) with the Secretary of State of the state in which the corporation will incorporate. Among other things, the Certificate of Incorporation must contain the corporation’s name and tax-exempt purposes (which should refer to Code section 501(c)(3) and include one or more of the words “charitable,” “educational,” “religious,” “scientific” or “literary”), as well as a provision that requires that the corporation’s assets be distributed upon dissolution only for tax-exempt purposes (unless applicable state law already so provides). It is important that the purposes of the corporation be carefully drafted to make sure that the purposes are specific enough to be accepted for filing (especially in New York), but still provide sufficient flexibility for the corporation to operate.

In New York, the Certificate of Incorporation must specify the type of corporation and the names and addresses of the initial directors (with a minimum of three required). In addition, if the corporation is incorporating in New York, other state agency approvals may be required before the Department of State will accept a Certificate of Incorporation for filing. For example, if the corporation’s name and/or purposes include or imply educational activities, the corporation must obtain the New York Education Department’s consent to file the Certificate (a process currently taking approximately 4-6 weeks).

Samples forms of Certificates of Incorporation are often available on Secretary of States’ websites. Note that many samples do not contain the language required to qualify as a tax-exempt organization under Code section 501(c)(3). The current fees for filing and obtaining a certified copy of a Certificate of Incorporation in New York and Delaware are \$85 and \$149, respectively.



The timing of the Department of State's acceptance of the filing varies. Many states offer expedited services, which should be used to the extent feasible. For example, in New York, 24-hour expedited service should be requested (\$25 fee per filing attempt) or it may take 2-4 weeks for the corporation's Certificate of Incorporation to be filed by the Department of State. In Delaware, the 24-hour expedited service fee is currently \$50 and same-day expedited service fee is currently \$100.

It is not uncommon for a not-for-profit corporation operating in New York to be incorporated in Delaware. The reasons for doing so vary, but incorporating in New York is generally more time consuming and a New York not-for-profit corporation must obtain approvals for certain fundamental corporate changes (e.g., changes in the purposes clause of its Certificate, mergers and dissolutions) from the New York State Attorney General and New York State Supreme Court (and, in certain cases, the New York Department of Education). Delaware law now requires a non-stock, not-for-profit corporation to have members (i.e., individuals who elect the corporation's directors and approve fundamental corporate changes such as Certificate and By-Laws amendments, mergers or dissolution). The members of a Delaware corporation may be the same individuals who are elected as the corporation's directors from time to time. In addition, Delaware law also requires a corporation to appoint a registered agent having an in-state business office. Firms that serve as Delaware registered agents generally charge fees ranging from \$165 - \$250 annually.

If the corporation is incorporated in Delaware, it must qualify to conduct business in New York or any other state in which it plans to operate (e.g., through employing individuals and/or renting office space). This is accomplished by filing an application for authority to conduct business in that state with the appropriate Secretary of State. The fees for filing and obtaining a certified copy of an Application for Authority in New York are currently \$145.

C. By-Laws.

By-Laws are the internal rules by which the corporation will be governed. The corporation's By-Laws should provide sufficient flexibility for the Board of



Directors to govern the corporation and the officers to manage the corporation. Generally, the By-Laws contain provisions relating to the election of directors and officers; the powers of its members (if any), directors and officers; quorum and voting requirements for member and Board meetings; processes for dealing with conflicts of interest; and provisions for the indemnification of officers and directors. Policies and procedures for managing the day-to-day operations of the corporation should not be included in the By-Laws but instead adopted by the Board of Directors as separate, stand-alone documents.

By-Laws are not required for incorporation. However, they should be adopted before the corporation submits its Form 1023 application for exemption to the Internal Revenue Service (the “IRS”).

D. Organizational Meeting.

After the Certificate of Incorporation is filed with the Secretary of State, an organizational meeting of the directors (and members, if applicable) must be held. At this meeting, the By-Laws will be adopted, the corporation’s directors (if not named in the corporation’s Certificate) and officers will be elected; the opening of bank accounts authorized; the filing of necessary state and federal filings and registrations, including the Form 1023 application for exemption, authorized; and any other business discussed. If the corporation was incorporated in Delaware, the incorporator (who signed the Certificate) will appoint the initial members of the corporation and adopt the By-Laws. The incorporator will then resign and the initial meeting of the members and/or Board of Directors should be held. Generally, any action permitted to be taken at the organizational or any other meeting of the members and/or Board of Directors can be taken without a meeting if each member and/or director signs a written consent setting forth the actions he or she is approving.

E. Employer Identification Number.

Every corporation must obtain an Employer Identification Number (“EIN”) from the IRS, even if it does not have employees. The EIN is a unique num-



ber that identifies the corporation to the IRS (as well as other federal and state agencies). Among other things, an EIN is generally required to open a bank account. To apply for an EIN, the corporation (after its incorporation) completes IRS Form SS-4 (Application for Employer Identification Number) and either (i) mails it to the IRS (processing time is approximately four weeks); (ii) faxes it to the IRS (processing time is approximately four days); or (iii) submit the application online at <http://www.irs.gov/businesses/small/article/0,,id=102767,00.html>. The online application must be submitted by a director or officer of the corporation, or a third-party designee of the corporation appointed by a director or officer (who names the designee on a completed IRS Form SS-4). There is no application fee to obtain an EIN. More information regarding applying for an EIN is available at www.irs.gov.

2. The Federal Income Tax Exemption Process.

A. IRS Form 1023.

The corporation, once incorporated, is considered a not-for-profit corporation for state law purposes. However, the corporation will be considered a taxable corporation for both federal and state law purposes unless it applies for recognition of its tax-exempt status with the IRS and obtains an IRS determination letter.¹ In order to apply for tax-exempt status under Code section 501(c)(3), the corporation must submit a completed Form 1023 – Application for Recognition of Exemption (available at www.irs.gov). The IRS will not process an incomplete application, so the application should be reviewed carefully to make sure it is complete and signed by an authorized director or officer.

If the Form 1023 is filed within 27 months of the date of the corporation's incorporation, its tax-exempt status will be retroactive to its date of incorpo-

¹ Exceptions to the Form 1023 filing requirement exist for churches and organizations that qualify as a public charity with gross receipts normally less than \$5,000 annually. Such organizations may, however, voluntarily choose to file a Form 1023 with the IRS to document their tax exemption.



ration. This is important for a corporation that wishes to accept contributions prior to receipt of its IRS determination letter.

Some areas to be aware of when completing the Form 1023:

- **Public Charity Versus Private Foundation Classification.** Organizations that are tax-exempt under Code section 501(c)(3) are classified as either public charities or private foundations. Private foundations are generally funded by a limited group of donors, i.e., one family, a handful of individuals or one company (e.g., the Gates Foundation) and are subject to very strict rules that can limit their operations. Public charities are split into several categories: (1) organizations that engage in inherently public activities (e.g., churches, schools, and hospitals); (2) organizations that receive a substantial part of their support from the general public (e.g., the United Way); (3) organizations that are funded primarily from receipts from the performance of their exempt function (e.g., theaters, museums); and (4) organizations that support organizations listed in (1), (2) or (3) above and are structurally linked to them. The public charity tests for organizations that qualify under (2) and (3) above are based on mathematical formulas that must be met on an annual basis (with new public charities given an initial 5-year grace period during which they do not need to meet the applicable support test).
- **Organizational Documents.** Copies of the corporation's organizational documents (i.e., Certificate of Incorporation and By-laws) must be provided with the Form 1023. The Certificate of Incorporation must be a certified copy showing proof of filing with the applicable Department of State.
- **Activities Description.** When describing its activities in Part IV of the Form 1023, the corporation should not just merely restate the purposes set forth in its Certificate of Incorporation. The IRS requires a detailed description of each activity the corporation proposes to conduct, with the corporation's activities divided into categories or "buckets" and similar activities placed in the same bucket to describe to the IRS. For example, all educational activi-



ties of a corporation should be put in the same “bucket” when describing them in Part IV of the Form 1023.

- **Financial Information.** The corporation will need to provide estimated financial budgets of revenue and expenses in Part IX of the Form 1023 for its first three tax years of existence (assuming the corporation has not yet completed a full tax year). The corporation will also need to provide a balance sheet for its most recently-completed tax year (or if the corporation has not completed a full tax year, the most current information available). The financial budgets of revenue and expenses in Part IX need only to be estimates; these estimates will not be binding on the corporation. However, the estimated financial budgets should be consistent with the activities description provided in Part IV as well as other responses in the Form 1023 regarding compensation and fundraising. The balance sheet in Part IX can consist of all zeros for a newly formed corporation.
- **User Fees.** User fees for the Form 1023 are now \$850 and \$400 depending on the amount of the corporation’s annual gross receipts reported in Part IX of the Form 1023.

Upon receipt of the corporation’s Form 1023, the IRS will send the corporation an “acknowledgment notice” confirming receipt of the Form 1023 and informing the corporation about the review process and timing. The IRS may request one or more supplemental submissions of information prior to making a determination about the corporation’s application. It can take anywhere from 2 to 8 months for the IRS to review and respond to a Form 1023 application.

B. Determination Letter.

If the IRS finds that the corporation qualifies for tax-exempt status, it will send the corporation a determination letter. The letter will state, among other things, (i) the effective date of the corporation’s tax-exempt status, (ii) the corporation’s classification as a public charity or private foundation, and (iii) the corporation’s obligation to file an annual Form 990 (or Form 990-PF, in the



case of a private foundation) with the IRS. The letter will include a booklet which provides information regarding activities that may jeopardize the corporation's tax-exempt status, the Form 990 or Form 990-PF returns that must be filed, recordkeeping, changes to be reported to the IRS, required public disclosures, and other relevant information.

3. New York State and Delaware Filings.

A. Registration to Hold Assets and/or Solicit Contributions.

If the corporation intends to hold assets and/or to solicit contributions in New York, it must prepare and file NYS Form CHAR410 with the Charities Bureau of the New York State Attorney General's Office, together with a fee (currently \$25) if it is registering to solicit charitable contributions. Sample documents are available at the New York State Attorney General's Charities Bureau website at <http://www.charitiesnys.com/>. The Form CHAR410 should be prepared and filed prior to soliciting contributions in New York State or as soon as the corporation begins holding charitable assets in New York State. The corporation does not need to wait to receive its IRS determination letter before filing the Form CHAR410; instead, the corporation may file the Form as soon as it files its Form 1023 with the IRS, provided that it sends a copy of its IRS determination letter (once received) to the Charities Bureau.

B. Franchise Tax.

The New York Tax Law requires the annual payment of a corporation franchise tax for the privilege of doing business in the state. Not-for-profit corporations, however, are typically exempt from this tax. If the corporation is incorporated in or is doing business in New York, it should apply for franchise tax exemption by completing and submitting NYS Form CT-247 to the New York State Department of Taxation and Finance.



Blank Forms CT-247 and the accompanying instructions are available at the New York State Department of Taxation and Finance website at <http://www.tax.ny.gov/>. The Form CT-247 should be filed immediately after the corporation has received its IRS determination letter; the exemption will not be granted prior to the corporation's receipt of its IRS determination letter.

If the corporation is incorporated in Delaware, it is required to file an annual franchise tax report with, and pay an annual franchise tax (currently \$25) to, the Delaware Secretary of State. There is no exemption from this filing for corporations that are tax-exempt under Code section 501(c)(3).

C. Sales and Use Taxes.

The State and City of New York impose sales and use taxes on many items that the corporation may need to purchase. The corporation should prepare and file NYS Form ST-119.2 with the New York State Department of Taxation and Finance to apply for an Exempt Organization Certificate to establish the corporation's exemption from these sales and use taxes.

Blank Forms ST-119.2 and the accompanying instructions are available at New York State Department of Taxation and Finance website at <http://www.tax.ny.gov/>. Form ST-119.2 should be filed promptly after the corporation has received its IRS determination letter; the exemption will not be granted prior to the corporation's receipt of its IRS determination letter.

4. Post-Formation Issues.

A. Annual Information Return: IRS Form 990 or IRS Form 990-PF.

Generally, not-for-profit corporations are required to file an annual information return with the IRS either on IRS Form 990 for public charities or IRS Form 990-PF for private foundations.



If the corporation is classified as a public charity, the type of Form 990 that must be filed will depend on the corporation's annual gross receipts and total assets. Information regarding filing thresholds for the Form 990 is available on the IRS website. The corporation must file its annual information return with the IRS by the 15th day of the 5th month after the close of the corporation's tax year. An automatic 3-month extension is available upon written request to the IRS with an additional 3-month extension available upon written request with reasonable cause. Substantial penalties may be imposed on the corporation if it fails to file by the filing deadline.

Blank Forms 990 and 990-PF and the accompanying instructions are available from the IRS website at www.irs.gov.

If the corporation is registered to solicit charitable contributions and/or to hold charitable assets in New York, it will also need to file annual financial reports with the Charities Bureau of the New York State Attorney General's Office. The corporation may also need to file annual financial reports with other regulatory agencies of any other states in which it is registered to solicit contributions.

B. Disclosure.

The corporation will be subject to various federal disclosure obligations. For example, under federal tax law, it must make the following documents available for public disclosure:

- Last three (3) years' annual information return (Form 990 or Form 990-PF) filed with the IRS;
- Last three (3) years' annual Form 990-T filed with the IRS;
- Application for Recognition of Exemption (Form 1023) including all correspondence with the IRS relating to the application; and
- IRS determination letter.

Copies of these documents must be available for public inspection at its principal office as well as any other office where it has three (3) or more employ-



ees during regular business hours. If copies of the documents are requested, the corporation may charge a reasonable fee for copying costs as well as for any actual mailing costs.

C. Solicitation of Charitable Contributions.

Most states require not-for-profit corporations that plan to solicit charitable contributions in the state to register with the state Attorney General's office. The registration process as well as the costs associated with registration will depend upon the number of states and the particular state or states with which the corporation registers. For example, in New York the registration fee is currently \$25; in Massachusetts, it is currently \$100.

The threshold for registering to solicit charitable contributions varies from state-to-state. For example, in New York, registration and annual reporting is only required if the corporation plans to or receives more than \$25,000 from New York sources.²

Failure to register can result in fines and penalties. Therefore, the corporation should pre-register prior to conducting any solicitation activities in a state that requires registration. In addition, as noted above, a corporation registered to solicit in a particular state is generally required to file an annual financial report with the state Attorney General's office.

A "solicitation" is broadly defined under state law and includes:

- a request for a contribution or grant (whether or not the contribution or grant is made);
- the actual receipt of a contribution or grant; and

² New York is the only state that sets the registration threshold based on revenues received from within the state. Other states use the organization's total revenues when determining whether a minimum threshold is met.



- any advertisement that states that the purchase or use of goods, services, entertainment or any other thing of value will benefit the corporation.

Solicitation also includes different methods of requesting contributions, including in person requests, written requests (such as through electronic media), telephone solicitations, fundraising events and foundation grant applications. A corporation's website invitation to "donate here" or similar message is generally considered a solicitation and requires that the corporation be registered in the state in which it maintains its principal place of business (assuming that state requires registration prior to solicitation of charitable contributions).

States may also require particular disclosure language be included in solicitation materials. For example, under New York law, the corporation must include in all written materials soliciting charitable contributions a disclosure statement regarding its registration with the Charities Bureau of the New York State Attorney General's Office.

D. Substantiation of Charitable Contributions.

The corporation must generally provide a tax substantiation letter to individual and corporate donors in return for their contributions. Specifically, an individual or corporate donor is not permitted to claim a federal income tax deduction for any charitable contribution of \$250 or more unless the donor has received a contemporaneous written acknowledgement (otherwise known as a "substantiation letter") from the donee corporation. In cases where the corporation provided goods or services to the donor in exchange for the contribution, the substantiation letter must include a good faith estimate of the value (not cost) of such goods or services. Taxpayers may no longer rely solely on a canceled check to substantiate a cash contribution of \$250 or more. The corporation's failure to issue a substantiation letter may result in the denial of the donor's income tax deduction and the imposition of penalties on the corporation.



The substantiation letter must be “contemporaneous.” This means that the letter must be obtained by the donor no later than the date the donor actually files a return for the tax year in which the contribution was made. If the donor’s return is filed after the due date or extended due date, then the donor must obtain the substantiation letter by the due date or extended due date for his or her return.

The donor, not the corporation, is generally responsible for substantiating his or her charitable contribution (i.e., by obtaining a substantiation letter). However, if the corporation knowingly provides false written substantiation to a donor, the corporation may be subject to penalties for aiding and abetting an understatement of the donor’s tax liability.

Effective in 2006, individual and corporate donors are now required to maintain a bank record or a written communication from the donee corporation indicating the amount of the contribution, the date the contribution was made and the name of the corporation. This requirement applies to all cash contributions (even those under \$250). Therefore, a donor to the corporation may also now request a substantiation letter for a cash contribution under \$250.

Additional information regarding substantiation of charitable contributions is available in IRS Publication 1771, which is available at www.irs.gov.



Useful links:

Life Cycle of a Public Charity page of the IRS website <http://www.irs.gov/charities/charitable/article/0,,id=122670,00.html>

Life Cycle of a Private Foundation page of the IRS website, available at <http://www.irs.gov/charities/foundations/article/0,,id=127912,00.html>

New York State Attorney General's Charities Bureau
<http://www.ag.ny.gov/bureaus/charities2/home.html>

New York State Department of Taxation and Finance website
<http://www.tax.ny.gov/>

GuideStar's website, an organization which gathers and publishes information about not-for-profit organizations
<http://www.guidestar.org>



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