

ASK THE NONPROFIT SPECIALIST HOW TO START A NONPROFIT

The rules governing nonprofit organizations are created by the federal Internal Revenue Service (IRS), the various States, and local Municipalities. They are complicated and they are volatile in that they can change, frequently as a result of economic, political, and social pressures.

A. Before you start:

There are five steps to follow in establishing a nonprofit organization in Arizona and there are several very good resources that will help you. But before you take any of these steps you must ask yourself two questions:

1. “Why do I want to start a nonprofit organization rather than a for-profit organization?”

Either form of organization may be appropriate for providing the service you wish to perform. And both types of organizations are businesses. So what is the difference? The following chart summarizes some of the main similarities and differences:

Functions	Nonprofit	For-profit
<i>Purpose</i>	Social good	Profit-making
<i>Form of organization</i>	Incorporation or informal	Incorporation, sole proprietorship, partnership
<i>Governance</i>	Board of directors	Board of directors, owners
<i>Taxes</i>	Federal Exemption for income to the nonprofit; State & local exemptions vary	Taxable
<i>Profits</i>	Non-distributable	Distributed to owners
<i>Staffing</i>	Paid & non-paid (volunteer)	Paid

2. “Are there other organizations in the community that do what it is I propose to do? If so: Is what I propose different than what any of them already do? Can I become a program of one of them rather than start a new business?”

In the United States there are approximately 1,600,000 nonprofit organizations of which about 800,000 are charities. In Arizona, there are more than 29,000 registered nonprofits of which about 19,000 are currently operating. It is reported that approximately 1500 new nonprofits are started in Arizona each year. Thus

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there are many others working to make our community a better place for all who live here.

Each of these nonprofit organizations serves a perceived need. In some cases, they are the sole providers of a service; in others, they are among several. It is important to determine whether your proposed program fills a specific niche or whether it may be a duplication. If it is the latter, the chances of developing financial support and clientele may be limited.

It is entirely feasible that your proposed program can be part of an existing nonprofit organization. Such might fill your desire to provide a needed service and it might expand the reach of the existing nonprofit in fulfilling its mission. Your market research should inform you of those potential organizations. Should such a partnership be successful, it is entirely possible that sometime in the future it might serve the purposes of all involved to spin off your program into a separate nonprofit organization. It is worth a serious conversation with those nonprofits to determine what is your best course of action.

In considering whether or not to form a nonprofit it is also important to realize that forming and maintaining a nonprofit has become increasingly difficult and expensive due to new regulations governing the sector. What was an extremely simple process now requires a clear mission and core of support. Make this decision with care. We strongly recommend you study the benefits and disadvantages as outlined by Anthony Mancuso in **How to Form a Nonprofit Corporation** NOLO 8th Edition. pp. 9-15

B. What is a nonprofit organization?

Before you go further, you are encouraged to download from the IRS site both Publication 557 and the Instructions and form for Form 1023.¹ Please read these. The information in them is extremely valuable and will help you make more informed decisions.

Nonprofit organizations represent individual or collective action to address a problem or enhance society in ways other than that provided through governments (federal, state, local) or for individual profit (corporate stockholders, partners, sole proprietors).

Bruce Hopkins, in his book, “Starting and Managing a Nonprofit Organization: A Legal Guide” quotes the 1973 congressional testimony of then Secretary of the Treasury, George P. Shultz, who said that charitable organizations “are an important influence for diversity and a bulwark against overreliance on big government.”²

¹ <http://www.irs.gov>

² Hopkins, Bruce, Starting and Managing a Nonprofit Organization: A Legal Guide, 3rd ed., Wiley Nonprofit Series, John Wiley & Sons.2004. Chapter 1 p.7

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Thus nonprofits are voluntary organizations with a primary purpose of serving the public good. They are exempt from federal taxes and many state and local taxes. This tax-exempt status is supported by a U.S. Supreme Court decision in which the following appears: “The State has an affirmative policy that considers these groups as beneficial and stabilizing influences in community life and finds this classification [tax exemption] useful, desirable, and in the public interest.”³

Additional rationale for tax benefits is found in a federal court of appeals decision: “One stated reason for a deduction or exemption of this kind is that the favored entity performs a public service and benefits the public or relieves it of a burden which otherwise belongs to it.”⁴

Some types of nonprofit organizations must evidence that they are publicly supported by proving they “regularly solicit funds from the general community”. Public support may include government funds. The IRS has developed various tests to help determine if one meets these requirements. These are known as the “public support tests”.⁵

Tax-exempt classifications are determined by the federal IRS. There are 32 different classifications of nonprofit organizations that receive exemptions from various taxes. Only 9 of these classifications may offer those who support it with grants and/or donations the right to declare their contributions as tax deductible. Charities with a 501 (c) (3) IRS classification comprise the bulk of those that can offer tax deductibility.⁶

Nonprofit organizations are not “owned” by anyone. The responsibility for legal and financial matters rests with its board of directors which is responsible for overall governance and stewardship. In some cases, the organization’s membership may “control” it by virtue of its power of vote for those who serve on the board of directors.

Members of nonprofit boards of directors serve without compensation except that they may be reimbursed for expenses incurred as part of their voluntary service. Boards of directors are responsible for assuring that the organization adheres to the principles of “no private inurement”, and the avoidance of “private gain” and “conflicts of interest”. These important principles are explained in the resources listed in this FAQ.

Nonprofit organizations may make a profit – as long as that excess of income over expenses is returned to the organization in pursuit of its mission. The expenses may include compensation paid to employees – as long as it is in accordance with community standards for the same work, thus avoiding issues of “private inurement” and “private gain”.

³ *ibid*

⁴ *ibid*

⁵ Mancuso, Anthony, *How to Form a Nonprofit Corporation in All 50 States*, 8th ed., NOLO Press. 2007. pp. 61-69

Chapter 4

⁶ IRS, Publication 557

Nonprofit organizations must file annual federal tax information reports, called Form 990. As of January 1, 2009 all nonprofits must file annual 990 forms. It should be noted that Forms 990 that have been filed with the IRS are made available to anyone over the Internet and a copy of such must be provided anyone who asks.⁷ Additionally, Arizona – and most states – requires annual registration as a charity along with a financial statement.

C. What a nonprofit organization is not:

There are certain precepts that a nonprofit organization must maintain in order to assure its tax-exempt status and the ability to offer tax deductibility to its donors. A nonprofit organization may not distribute profit to individuals in their private capacity. Charities must be organized and operated so that “no part of... [its] net earnings... inures to the benefit of any private shareholder of individual.”⁸ They may not solicit or receive contributions directly for specifically named individuals. They may not offer opportunities for private gain to any of its directors, trustees, officers, or key employees. As an organization governed by a board of directors, no one person may hold control. Nonprofits are held to the highest standards of public trust; they may not keep secret their standard annual tax information reports (IRS Form 990).

D. Five step process:

1. Thoroughly researched business plan with market analysis.

See <http://www.boardsource.org> for information on governance and strategic planning. A basic plan consists of, minimally, the following components:

- Mission of potential organization
- Description of service or product
- Need or marketability of service or product
- Analysis of marketplace including full descriptions of real or potential competition
- Cost projections over 5 year period
- Income projections over 5 year period
- Expertise needed to perform service or product projections
- Board of directors
- Biographies of you, the board of directors, and other key people. Be sure to note expertise in service, program, management, and governance.

Financial support in the forms of grants and donations can be very difficult to obtain in the first few years. In addition to keen competition from well-established nonprofits, new organizations must prove their market niche,

⁷ <http://www.guidestar.org>

⁸ Hopkins Chapter 5 p 56

Arizona State University
Lodestar Center for Philanthropy and Nonprofit Innovation

expertise, and stewardship of resources before many funders and donors will help support them. Therefore, a thoroughly researched business plan is essential.

2. State Incorporation (fee is charged)⁹:

Register with the Arizona Corporation Commission. This incorporates your organization as a nonprofit. You do not need to incorporate but there are multiple reasons to do so including protection from personal liability.¹⁰ You may access the information and the forms you need via Internet: <http://www.cc.state.az.us> A similar process will be required in any other state; information is available via each state's website or Mancuso's "How to Form a Nonprofit Corporation in all 50 States."

Note: In Arizona, while you are preparing to start a nonprofit, you may – in advance – reserve the name you have created for your organization. The Secretary of State and the Corporation Commission offices have registration of trade name forms.

3. Obtain EIN:

The Employer Identification Number (EIN) is the equivalent of your corporation's federal ID number, similar to your own social security number. The form for obtaining this number is SS-4, available over the Internet at www.irs.gov. The easiest and quickest way to get an EIN is to apply online from the IRS website. Go to www.irs.gov and type "EIN" in the upper search box. Then click "Go to open a page that lists links to EIN-related Web pages. You should see a link to the online EIN application¹¹
<http://www.irs.gov/businesses/small/article/0,,id=102767,00.html>
You will need this number for banking and for the next step.

4. File IRS Form 1023:

This is the final step in obtaining your tax-exempt status; it can take up to 6 months depending upon the IRS office through which you must file. This form requires considerable attention. Each time the form is returned to you for further information or clarifications, the time for receiving your exemption is extended thus it is advisable to ask legal counsel versed in nonprofit law to review the form after you complete it but before you send it in.

BEFORE you complete this form, you are urged to review any of the following references and/or to read carefully Publication 557 and the Instructions for completing Form 1023 available over the Internet from the IRS site <http://www.irs.gov> Look for information on Tax-Exempt

⁹ Some of the resources below are specific to Arizona. Visit your state website, usually www.state.xx.us (xx=postal abbreviation for your state), and search for similar departments and/or tax-exempt and/or nonprofit.

¹⁰ Hopkins; Mancuso

¹¹ Mancuso, p 148

Arizona State University
Lodestar Center for Philanthropy and Nonprofit Innovation

Organizations. Your business plan will provide valuable information for completing the form; a part of the requirements is your income projections over the next 4 years. (Remember to familiarize yourself with the Public Support requirements.) Upon acceptance you will receive a Letter of Determination. Be sure to permanently file the original; copies will be requested by various agencies and funders.

How long is the turnaround time at the IRS? According to Anthony Mancuso, How to Form a Nonprofit Corporation, 8th edition (2007) p 198 the IRS should inform you that they received the application within three weeks. While the turnaround time for completion of review of your Form 1023 is normally about 2 months, you may have to wait three to six months. It is possible to request an expatiated filing by submitting a written request along with the application. Successful reasons can include an impending grant deadline, providing disaster relief, delay of prior application.

5. Register with State (fees may be charged):

Before charities may solicit contributions they must file with the Arizona Secretary of State -- and annually in September thereafter. Your latest Form 990 must be attached. Most states require a similar process.¹² Instructions and forms are available over the Internet http://www.azsos.gov/business_services/filings.htm There are additional requirements if you hire contract solicitors.

The Arizona Corporation Commission requires the filing of an annual report each year. The forms will be sent to you. Your latest Form 990 must be attached. Go to <http://www.cc.state.az.us> for information over the Internet.

Registration with the Arizona Department of Revenue is required to obtain tax exemption. Contact the department to determine if you are exempt from sales tax. <http://www.revenue.state.az.us>

If you will be employing persons, register with the state unemployment insurance bureau. Information and forms are available at <https://www.azdes.gov>

Note: You will need to complete numerous forms for various regulatory agencies. It is your responsibility to research and know these. Some of these are referenced below:

¹² http://www.azsos.gov/business_services/filings.htm

Arizona State University
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1. You may also wish to apply for a nonprofit mailing permit from the US Postal Service. <http://www.usps.com/businessmail101/misc/nonprofitApplication.htm>
2. Obtain directors and officers liability insurance. Go to <http://www.nonprofitrisk.org> for information about risk management and insurance.
3. Understand if you need special licenses or permits for your specific area of service. Professionals and accrediting agencies will be helpful.
4. Contact your county assessor to determine if you might qualify for property tax exemption. In the state of Arizona most nonprofits do not qualify.
5. Seek assistance in establishing accounting processes and procedures. Understand the rules for filing the IRS Form 990 which is a public document.

E. Five topics to know for your success:

Each of the following topics is essential to your success. Information about them is available at the various resources listed below. In addition, the ASU Lodestar Center offers 12-16 hour courses through its Professional Development Education program. Please see the course schedule posted on the web site.

- Governance: what are legal responsibilities of boards of directors; how do they operate
- Financial Management: what are the basic accounting and audit requirements; how to develop and read nonprofit financial statements
- Program Evaluation Knowledge: how to develop programming and evaluate for effectiveness.
- Resource Development: how to develop donor relationships that lead to effective fund raising; foundation and corporate fund raising.
- Nonprofit Law and Ethics: what specific laws to know and how to make decisions that are ethical and sound.

F. Resources

Education and Training:

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Lodestar Center for Philanthropy and Nonprofit Innovation

- “How to Start a Nonprofit”; offered semi-annually; includes review of forms and Federal and State processes.
- 16 courses, 12-16 hours each, on topics of importance to nonprofit leadership and management; can lead to the Certificate in Nonprofit Management

Area community colleges and professional and trade associations offer a variety of courses on nonprofit management issues throughout the year. These are often published in school catalogs and through mailings distributed to nonprofit organizations.

Publications:

Hopkins, Bruce, Starting and Managing a Nonprofit Organization: A Legal Guide, 4th ed., Wiley Nonprofit Series, John Wiley & Sons 2004

Mancuso, Anthony, How to Form a Nonprofit Corporation in All 50 States, 8th ed., NOLO Press 2007

Websites:

Arizona Corporation Commission <http://www.cc.state.az.us> (Incorporation, forms)

Arizona Department of Economic Security <https://www.azdes.gov>
(Unemployment law and insurance)

Arizona Department of Revenue <http://www.revenue.az.gov> (State sale tax exemptions)

Arizona Secretary of State <http://www.azleg.state.az.us/ars/44/06552.htm>
(Registration and annual filing as tax-exempt organization)

BoardSource <http://www.boardsource.org> (Nonprofit governance information)

Foundation Center <http://fdncenter.org/learn/faqs/html> Includes FAQ section on how to start a nonprofit.

Guidestar <http://www.guidestar.org> (Nonprofit information including 990s)

Grand Valley State University, “How To Start a Nonprofit”,
<http://www.gvsu.edu/philanthropy>

Internal Revenue Service <http://www.irs.gov> (Tax exemption application and EIN number)

Arizona State University
Lodestar Center for Philanthropy and Nonprofit Innovation

Miller, Steven T. Director of Exempt Organizations at IRS, article, “Easier Compliance Is Goal of New Intermediate Sanction Regulations”. Internal Revenue Service <http://www.irs.gov/pub/irs-tege/m4958art.pdf>

Nonprofit Risk Management Center <http://www.nonprofitrisk.org>
for information about how to assess your needs and types of insurance.

(This list of questions regarding “How Do I Start a Nonprofit?” has been developed by the many persons and organizations seeking assistance from the Lodestar Center for Philanthropy and Nonprofits Innovation. We invite you to add your questions and reactions through the “Ask the Nonprofit Specialist” section of the center’s website so that we might improve and expand these FAQ. Updated, revised 2-09 RD, PFL)