

Setting Up a Nonprofit Organization

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A nonprofit organization, or tax-exempt business, does not distribute any profits to its owners, just as its name suggests. All money left after expenses is put back into the business or used for charitable purposes in the community. *Nonprofits*, as these organizations are typically called, include most charities and also are found in such sectors as the arts, education, research and health care. This article looks at various types of nonprofit businesses, how they are organized, and how they can obtain financing to fund their activities.

What You Need to Know

What is the difference between a nonprofit and a not-for-profit business?

There is no legal difference at all. However, businesses that want to differentiate themselves from charitable organizations may refer to themselves as “not-for-profit.”

Can any business be tax-exempt?

No. Nonprofit businesses are tax-exempt because they do not distribute profits as dividends to shareholders or as income to owners. All “profits” from the business are immediately reinvested in the organization. Nonetheless, some states assert that there are many advantages to being a nonprofit entity.

What kinds of tax-exempt businesses exist?

Organizations that can qualify for tax-exempt status include corporations, social services providers, private funds, trusts, research firms, firms established to promote specific causes (the American Cancer Society, for one) and a variety of foundations. Nonprofit organizations do not have to incorporate, but in many cases it is recommended to protect their leaders and board members from personal liability.

What is a credit union?

A credit union is a cooperative that provides members with sources for saving, borrowing, and other financial services. It is set up, owned, and operated by its members, who collectively save to create a pool of money from which low-cost loans are made. Credit unions, too, are tax-exempt.

They can operate under either a state or a federal charter. The charter can affect member benefits and operating practices, so potential members should check out a credit union's structure before becoming a participant.

In most cases, credit unions cannot extend business services and loans. Some small businesses use credit unions for their banking needs and can do legally; however, credit unions cannot provide banking services to corporate entities.

What to Do

Establish Tax-exempt Status

Experts assert that, though nonprofit, you still need a business plan. At the top of the list of things to do is, of course, to establish your tax-exempt status. Usually a nonprofit business is either an unincorporated association or incorporated as a company without invested capital or shares. Once you have decided to form a nonprofit, you should contact the office of the applicable secretary of state. It can provide you with the appropriate application forms and lists of rules and regulations that your organization will need to follow.

Be sure to ask for any other applicable guidelines from your state, county, or municipality that may further explain regulations that govern charitable and nonprofit organizations. Rules may cover charitable solicitations, hiring, employer payroll and unemployment tax requirements, applicable sales and income taxes under state and local law, and other matters of interest. These rules can vary by state.

If you decide to incorporate, you will need to prepare and submit articles of incorporation. In this case, your organization should work with an attorney to ensure you complete and file the appropriate paperwork at the proper times.

Once you have established your organization as a tax-exempt entity, you will receive an official letter granting nonprofit status. Upon receipt of that letter, contact the Internal Revenue Service for the appropriate forms to file for federal recognition as a tax-exempt organization. This step is required to be eligible to receive tax-deductible donations. Indeed, many donors won't even consider a making contributions to a group that lacks this status.

Establish a Board of Directors

If your nonprofit organization is incorporated, you will be required to form a board of directors or trustees. Technically, the terms “director” and “trustee” can be used interchangeably. However, unless your nonprofit is a legal trust, “trustee” tends to describe advisory board members rather than a formally appointed or elected “director.”

Directors have a fiduciary responsibility for the organization. They are not figureheads, nor should they be treated as such. Corporate governance and oversight is of particular importance, which means that you should be particularly careful in selecting board members. Once you have the board in place, you will be well advised to ask for its counsel and to keep directors well informed about the status and direction of the organization. Directors are usually selected because they have a specific expertise or influence, not the least of which is being a source of funding.

Determine a Set of Bylaws

A nonprofit organization is also expected to establish a set of bylaws that guides its operation, current and future activities, and election of officers and board members. In many cases, the bylaws are submitted with the application to the state for tax-exempt status.

In addition to guiding activities, bylaws articulate your organization’s mission and reason for existence and identify the constituencies you serve. They detail the structure of the organization, the role of the board, management expectations and requirements, and day-to-day operating guidelines. Bylaws also serve as the ultimate authority should disputes arise within the organization. Ask your attorney, secretary of state, or county or municipal government oversight office for samples of bylaws that they recommend for your review. Samples also are available online as part of various nonprofit organizations’ web sites.

Consider Funding Options

College courses are taught on this subject, as there are that many variables to consider! Many nonprofit organizations look for grant money to cover all their costs. Grants might come from large companies, charitable foundations or trusts established for the purpose, a state government or the federal government. Remember, though, that there is far more demand for grant money than money available.

Accordingly, it’s common for charitable and tax-exempt organizations to rely on donations to cover their costs. In these cases, a percentage of the donations is allocated as administrative fees. If donations are to fund your organization, it’s best to keep administrative fees to a minimum. Many donors choose the nonprofit organizations they support based on the percentage of the contribution that reaches the population to be served; obviously, the higher that percentage, the better.

Sometimes newly established tax-exempt organizations ask a more established nonprofit to act as a fiscal sponsor, as they test the waters to determine their long-term viability while expenses—and risks—are still low. If the new group is a coalition of others working jointly on a common issue, a fiscal sponsor may be a logical depository for accepting funds. If the group is committed to a mission, but simply lacks the experience or interest in managing the requisite administrative functions of a business, a fiscal sponsor could be a good option.

Be Aware of the Legal Standing of Unincorporated Associations

An unincorporated association does not have a separate legal identity from its owners: It is simply a collection of individuals. The association normally has a constitution that sets out its aims and objectives. It will also have a committee, normally elected during an annual general meeting at which members are nominated to serve as officers and members. Committee members are all personally liable for debts incurred by this kind of business, an obligation they need to understand before accepting a position.

An unincorporated association cannot initiate legal action, borrow money, or enter into contracts in its own name, for it has no legal identity of its own. Nor can an unincorporated association hold property without appointing trustees (usually committee members) to do so on its behalf. There are no formal registration requirements for setting up an unincorporated association.

Conduct Regular Audits

Many nonprofit organizations and associations have defined audit requirements during which state or federal auditors review their finances. Find out from your tax advisor or attorney how frequently these audits occur and how best to prepare for them. You can also acquire resources from The American Institute of Certified Public Accountants. A periodic audit is always a good idea whenever money changes hands. It's not uncommon for a professional accountant who is a member or advisor of the nonprofit to conduct the audit at no charge or for a minimal fee. Although a "hold-harmless" agreement may be requested to protect the interest of the individual or firm, it's a reasonable request.

What to Avoid

You Take Bad Advice

The consequences of bad advice can be severe. Establishing and managing any nonprofit organization is a complex and detailed process, whether or not it is incorporated. Moreover, there can be personal legal implications for those in charge of the organization should any real or perceived

malfeasance appear. As a result, you should make sure that you are working with capable attorneys, accountants, and advisors who specialize in nonprofit and not-for-profit organizations.

You Don't Take the Task Seriously

The management and direction of a not-for-profit organization should be taken as seriously as the management of a for-profit organization. Indeed, the operating practices of the most successful nonprofits are known to be role models for capitalists to emulate.

Where to Learn More

Book:

Welytok, Jill Gilbert. *Nonprofit Law & Governance For Dummies*. Wiley, 2007.

Web Sites:

idealist.org: www.idealists.org

The Nonprofit FAQ: <http://nonprofits.org>

National Council of Nonprofit Organizations: <http://ncna.org>