

How to Become a Tax-Exempt 501(c)(3) Non-Profit Organization

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I am not a tax lawyer. I am only some poor fool that is part of a group who recently became a 501(c)(3) non-profit, tax-exempt corporation under the tax code of the United States Government. The following are my anecdotal experiences and lessons learned working through this process to become a non-profit, tax-exempt corporation as a result of being awarded a state grant and the need to manage that and donated monies. You are strongly advised to consult with an attorney who has experience with these matters in your own state.

In the Beginning

So you have a new cause and you wish to solve a problem and change the world. You have gotten together with like-minded people, had a few meetings, and invited a few guests to tell you what you need to do to go forward and succeed. Perhaps, a government organization or representative has indicated that there are funds available to solve your problems. And perhaps, a great many people have handed you checks, to help you go out and follow your cause. You and your associates have recognized that you will need funds to do this work. Now you begin thinking that you might need to be a non-profit tax-exempt organization in order to protect these donations or potential grants from income tax. In our case, the State insisted that if we were to administer our own grant (which we successfully wrote and obtained), we needed to become a tax-exempt 501(c)(3) organization.

Therefore, the very first thing your new organization will need in this process is a viable potential for funding. This can be large numbers of donations from the public, or it can be an awarded grant. If the money hasn't poured in from the public, the first step of your organization will be to write a grant proposal. Get help writing your grant from anyone offering help (state officials and anyone else with previous experience.) Slog through the process, be patient and occupy your committee with activities that support your cause, solicit donations¹, and continue your meetings. Once you have the potential for funding, you have the necessary motivation and ingredient for becoming a 501(c)(3) non-profit tax-exempt organization, money.

The hypothetical situation that I will address for this process is this:

- You and your volunteers have successfully written a grant or solicited donations.
- You have been notified that you have been awarded the grant.
- You have been informed that in order to administer the grant, you must become a tax-exempt 501(c)(3) non-profit organization (or be willing to pay the taxes on the money), or you recognize that, in order to shelter your money from income tax, this is necessary.
- You are motivated to attempt this transformation of loosely knit volunteers to a formal organization in order to administer a grant or shelter your donations.
- You cannot access your grant money, even for operational funds until this transformation is complete.

The definition of having completed this process will be your receipt of a "letter of recognition of tax exemption" from the United States Internal Revenue Service (IRS).

So I emphasize, that in conjunction with obtaining recognition of tax exemption, one of your first priorities of your organization will be to establish the working parameters of your grant award with the granting authorities (a Work Plan), which will require the establishment of a detailed budget for your grant, goals, definitions, timelines, and limits of responsibility and authority (much

¹ At this point, you may not assert to anyone donating that their donations will be tax deductible.

of which can be taken directly from the grant application you have already successfully written). If you just have donations, you will wish to establish the same budget, goals, definitions, timelines, etc. The IRS will want to know about the general outline of these decisions.

On the Road to Non-Profit Tax-Exempt Status

On your way to becoming a 501(c)(3) non-profit tax-exempt corporation, you must first incorporate as a Non-Profit Corporation. Remember non-profit and tax-exempt do not mean the same thing; non-profit means the bottom line is zero at the end of the year - no profit, and hopefully no debt. Tax-exempt means that you don't have to pay federal taxes on the money that came through your organization.

In its simplest form, this means that you register your corporation's Articles of Incorporation with your state. The Articles of Incorporation outline basic principles of your corporation, such as: your corporation's name, duration of its planned existence, exempt purposes, specific purposes, membership, directors, prohibitions, dissolution conditions, registering agent and office, incorporator's name, and indemnification clause. You will need to register a set of Articles of Incorporation, under the laws of your state, supply a minimum of 3 directors for your corporation: President, Vice-President, and Treasurer/Sec., and establish (and perhaps register) By-Laws for your corporation.² Your Articles of Incorporation must contain the correct verbiage for a tax-exempt 501(c)(3) corporation via IRS rules. Note that if you do not have the correct statements in regard to your non-profit intent and your willingness to abide by 501(c)(3) tax code's rules, then you probably will not succeed in acquiring your letter of recognition of tax exempt status from the IRS and you will have to unincorporate your flawed Corporation and reincorporate, if you wish to succeed. You may be required to pay a registration fee to your State when you register your corporation.

After you have successfully incorporated, start collecting tax identification numbers from the State (CRS number from the State of New Mexico) and from the Federal Government (EIN-employer identification number) for your corporation. Now you can get a bank account; you will need the tax identification numbers to establish a bank account (these numbers are like a Social Security number for your corporation). Note that someone will have to pay the State fees for incorporating in cash or out of someone's personal account, as you will not have any of these tax identification numbers before you incorporate and you can't have a bank account for your corporation until you incorporate – catch 22.

To become a 501(c)(3) non-profit tax-exempt corporation, you next need to apply for Tax-Exempt Recognition (IRS Form 1023 and associated other forms). In order to 'prove' to state entities, other granting authorities and businesses that your organization is classified as a tax-exempt 501(c)(3) organization as defined by the United States government and the IRS tax codes, you must successfully fill out and submit IRS Form 1023. Once you have a 'letter' from the IRS recognizing the tax-exemption status of your organization, you will have successfully reached a safe resting point in the process (four-five years in length). Granting authorities will breathe easier since you can now 'prove' that you are a tax-exempt organization and their money allocated for the operation of your organization (assuming you have been awarded a grant) will not be taxed as income by the federal government. Once you formally acquire your tax-exempt recognition status, I am told you will need to re-register your Corporation with your state as a non-profit and now tax-exempt Corporation.

Consider Timing

Many may tell you that you have 15 months from the initial date of incorporation to submit Form 1023 to the IRS. This is technically true and a requirement; you must submit Form 1023

² By-Laws are an internal set of rules for the operation of your organization, i.e. how everyone will be notified of meetings, how far in advance, and by what means, etc.

within 15 months of incorporating or gives some good excuses. Also technically true is that the IRS will require you to be in business 4 years before they will even consider issuing you a definitive ruling on your organization's tax exempt status.³ Further, it is technically true that your organization is considered a tax-exempt 501(c)(3) organization from the first day of incorporation even without the tax-exempt recognition letter from the IRS (so long as you apply within 15 months of incorporation, etc.) But when negotiating a Work Plan for our newly awarded Grant, our state balked at recognizing our corporation as a tax-exempt organization before we submitted Form 1023 to the IRS (even within the time window for application), or after we submitted Form 1023 and could give them a copy of the submitted forms within the time window for application (but before we received the 'letter' of tax-exempt recognition from the IRS).

You do not want a definitive ruling of your tax exempt status; you will not have been in business long enough and don't want to wait four years to prove you are viable and you won't be able to do tax-exempt 501(c)(3) business without the ruling, in order to prove you are viable. And finally, even though the IRS may treat you and all that deal with you (donators, etc) as a tax-exempt 501(c)(3) organization for 15 months without a letter of tax-exempt recognition, the granting agencies may not.

Therefore, you will need to acquire as quickly as possible an advance ruling of your tax-exempt status from the IRS. And so, you will need to apply through Form 1023 "Application for Recognition of Exemption" soon after you have successfully incorporated. (Don't wait 15 months – the granting organizations will want this 'letter' before they will give you access to your grant.) Once submitted to the IRS, and the process runs along normally with no problems, it is said that you will receive your 'letter' in 3 to 4 months.

Collect Enough Money

Most grants do not provide funds for start up costs and the establishment of your new corporation. Even if you have been awarded a grant, you will need cash to begin this process such as:

- Fees for becoming incorporated. (\$20 – New Mexico)
- Cost to purchase checks and open a new bank account (\$100 in our case)
- Mailing and filing expenses (\$50)
- Submission fee to IRS with Form 1023 (\$500)
- Purchase liability insurance (Ranging from \$300 - \$600)
- Volunteer labor and equipment (computer, printers, paper, etc.)
- Tax Lawyer (\$200-\$500 from a sympathetic Attorney)
- Bookkeeper or accountant (Outsource or have someone with experience volunteer)
- Fund raising will become a consideration, and the IRS will want to know how you intend to proceed with this necessary process.

Consider the following points, when incorporating and framing your organization:

Is your organization a Corporation, Trust, Association, or Private Foundation? I don't know anything about Trusts, or Associations (and also Private Foundations – but if you are this, it disqualifies you for tax-exempt status). The Greater Eastern Jemez Wildland Urban Interface filed as a corporation.

³ The IRS will consider issuing a *definitive ruling* after a minimum of 9 months, but will review how well your corporation is being received by your community by the amount of donations/grants it has acquired. My understanding is that the IRS is trying to judge if your organization is viable and has a future and the best way to prove this to the IRS is to show you have a successful past lasting at least 4 years, or that you are receiving tons of monetary support from the public. The *advanced ruling* that new organizations are seeking gives your new corporation a 5-year window to establish a track record for the IRS.

The IRS wants to know if your organization is operating (or going to operate) in an ethical manner, and wants to know if it is tied to other organizations or “disqualified” people, or intends to engage in transactions with political or other exempt organizations (other than 501(c)(3) organizations) or has financial ties with others? The IRS also wants to know if you have a membership (and by extension dues) or don’t have members (i.e. an Association)? Will your organization be dabbling in politics? How do you intend to do business – what your goals are, and how will you intend to proceed to accomplish them? Will you treat everyone fairly and equally?

You will need to file Form 1023 within 15 months of forming your corporation – if you take longer, you will have to give good excuses. You and your corporation will wish to qualify “as receiving a substantial part of its support in the form of contributions from publicly supported organizations, from a governmental unit, or from the general public”. If you have been in business for over 4 years – you must know what you are doing, so follow the instructions; if you are new to this you want an “advanced ruling.”

The IRS will want a Statement of Revenue and Expenses and a Balance Sheet. Since you will have been in business for only a couple of months and you do not have much money, only the current year should reflect real revenue and expenses. The IRS will also want a budget of what you intend to receive and spend for the next two years. A fee of \$500 is charged by the IRS, however there is an option for only a \$150 fee. You will need to certify that you are a small organization and intend to remain that way for four years with gross receipts not averaging more than \$10,000 during that time period. I suggest that you do not limit yourself in this way and be prepared to write a check for the full amount. The IRS will want a “conformed copy”. This is a signed copy of your Articles of Incorporation (see the first step), a copy of your By-Laws, and a certificate stating you are in good standing as a corporation with your state.

People, Money and Conflict of Interest

I have been told anecdotally that we have personally experienced, in what has been characterized as common for naïve and basically ignorant beginning organizations, the separation of fools from their money. When personal self-interest comes in conflict with the organization’s interests as a whole – this is a “conflict of interest”. You would think that this would be easy to identify before it occurs. Our experience is that it is not.

Our experience had a very motivated, dedicated, and resourceful individual whose intentions were mostly positive, but attempt to shape the organization in such a way as to create a salaried role for himself. The individual was volunteering his own time and was being reimbursed for expenses, but was also trying to create a structure where a percentage of donated or grant monies be set aside for “salary and operating” expenses. This of course takes needed money away from the goal of your organization.

So how does your group avoid these pit falls? Some suggestions are:

- Distribute power as broadly as possible – by having more than the minimum required number of directors for your corporation. Do not allow your group to abdicate responsibility to only one individual. The more fingers in the pot, the more difficult to manage, but also the individuals most likely to be attracted to unilateral power will not see an opportunity and either become productive members of the organization or leave.
- Distribute the workload as broadly as possible – by encouraging people to form subcommittees to see the work gets done. It isn’t fair to expect one person to accomplish the entire process. If he/she is good hearted and committed to your ideals you may lose them due to the demands. The broad distribution of work will increase the management

problems, and things that are necessary may not get done quickly or at all. A strong leader is needed to make sure all the jobs at hand are specified and with time limits.

As a loose knit committee, take time to set ground rules for money, time and effort. Agree up-front that the seed money will only be used to pay for certain 'group' determined items. If unanticipated expenses come up and are not part of your group's list, then develop a system where the individual must get prior approval from the committee. Establish budgets for acceptable expenses to keep costs within reasonable limits. When the budgeted amounts are spent, your group will either find new contributions to cover new expenditures or decide not to spend for that category.

In the End,

Good Luck – and don't give up. If you do, you will know it wasn't worth doing in the first place. You can find out more about the Greater Eastern Jemez Wildland Urban Interface by visiting our website at www.jemez.org/mitigation or if you have questions contact me via email at abcooke@sulphurcanyon.com.