

Starting a Non-profit in Arizona

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I receive several calls a week from people who want to start a new non-profit. Looking back on my legal career, I realize that many of the tax-exempt organizations I helped to create early on never got off the ground. Today, I consider it part of my responsibility to the potential new client and to the sector to educate would be founders on the realities of the marketplace. What follows is a walk through the typical discussion that I have with potential founders.

I. Laying the Groundwork.

1. Does the Idea Have an Exempt Purpose? Not every good idea is something that will qualify for tax-exempt status. Examples include: making investments in start-up companies; providing benefits limited to a relatively small and defined class; and ideas for businesses that are indistinguishable from for-profits except that they commit to contribute profits to charity, just to name a few.

2. Running a Charity is a Competitive Business. Starting a nonprofit is a lot like starting a business. Rather than looking to access investors in the capital markets, charity start-ups are looking to access donors in the philanthropic markets. Would be founders need to know that there are already 1.4 million charities in the United States and competition for philanthropic dollars is fierce and grants are the smallest and most competitive piece of the philanthropic funding pie.

3. Survey the Landscape. Today's funders strongly discourage duplication of services. To get a realistic idea of your chances of attracting funding, research other non-profit organizations that are similar to the organization you propose. If there are others filling the niche and filling it well, do you have a plan to deliver the service in a new, innovative way? If you can't differentiate your organization, it is going to be very difficult to attract philanthropic support.

4. Do Your Homework. To obtain 501(c)(3) status, non-profits have to present the IRS with a detailed business plan. A business plan is not a mission statement. It is a statement that answers what you plan to do, when, where, how, by whom, for how much and with what funding. The IRS will also want to see a qualified and mostly independent board of directors. This can present a frustrating chicken and egg

problem for many would be founders. If you can't answer these questions in detail, consider whether you are really ready to start a non-profit.

5. Consider Alternatives. The cost in both time and resources to create and maintain a new non-profit can be daunting. Alternatives to creating a new entity include:

- partnering with an existing organization as a volunteer or fundraiser;
- creating a donor advised fund;
- finding an established charity with a related purpose to act as a “fiscal sponsor” of the project; or
- starting a chapter of an established national organization.

After discussing the above, if the potential founder is still ready to proceed, the next step is to review the actual mechanics of creating the organization and applying for tax-exempt status.

II. Forming the Entity.

Once a non-profit founder has surveyed the non-profit landscape and found a legitimate need, recruited an initial board, created business and fundraising plans, and scraped together some start-up funding, he or she is ready to proceed. In Arizona, it usually makes the most sense to form the entity as an Arizona non-profit corporation. Very generally, the steps to creating a new non-profit corporation in Arizona are as follows:

1. Prepare and File Articles of Incorporation. The filing of the articles of incorporation begins the organization's legal existence. To qualify for tax-exemption, the articles must limit the corporation's activities to tax-exempt purposes. The purpose statement should be broad and flexible enough to give the organization room to evolve, without being so all encompassing that it would permit it to engage in non-exempt activities. The articles must permanently dedicate the corporations' assets to tax-exempt purposes and must not permit distribution of profits to private individuals. If the Articles do not meet these basic IRS requirements, the IRS will require amendments and may only grant exemption from the date of the amendment rather than retroactive to the date of incorporation.

2. Prepare the Bylaws. The articles and bylaws collectively form the governance structure for the corporation. Perhaps most importantly, they prescribe how the board of directors is selected. In Arizona, directors can be selected by board vote, by designation of a third-party, by one or more members or delegates, or through a combination of these methods.

3. Prepare Governance Policies. We recommend that newly formed corporations adopt certain key governance policies. Arizona law requires certain Arizona non-profits to have a Conflict of Interest Policy. Whistleblower and Document Retention

and Destruction Policies help the corporation avoid violations of Sarbanes Oxley's criminal provisions. Other governance policies that are typically considered at this stage include Gift Acceptance Policies, Compensation Policies, Travel and Expense Reimbursement Policies, and Joint Venture Policies.

4. Hold Organizational Meeting. At the organizational meeting, the directors will approve the corporation's articles and bylaws, elect directors and officers not identified in the Articles, adopt governance policies, pass a banking resolution authorizing the opening of a bank account, authorize the hiring of the chief executive and any conduct other initial corporate business.

5. Obtain Tax Identification Number. In order to open bank accounts, the corporation will need to obtain a tax identification number from the IRS. It is very important that the number not be obtained before the organization is formed because the identification number cannot attach to a corporate entity that does not yet exist.

In Arizona, the time required to accomplish these steps depends on how complex the governance structure is, how quickly the founders can make the necessary decisions, and how quickly the Arizona Corporation Commission can process the articles. If the articles are filed on an expedited basis, a new Arizona non-profit corporation can usually be formed a few days.

III. Applying for Tax-Exempt Status.

Having a nonprofit corporation is not the same as being tax-exempt. To obtain 501(c)(3) status, newly formed entities must apply to the IRS for a formal determination of exemption. Entities seeking 501(c)(3) status apply by filing Form 1023. (Entities seeking exemption under other sections of 501(c) file Form 1024.)

Newly formed organizations applying for exemption face a chicken and egg dilemma. Form 1023 requests considerable detail regarding the charity's planned programs and activities. The attitude of the IRS is that requiring applicants to articulate detailed plans is a small price to pay for the significant tax benefits associated with 501(c)(3) status.

1. Narrative Statement. Newly formed organizations often struggle to articulate their plans with the level of specificity the IRS demands. We generally try to provide at least a paragraph describing the who, what, when, where and how of each of the entity's separately identifiable programs. Narrative statements that are very brief tend to elicit additional questions from the IRS. Narrative statements that go on for pages create an impression of trying too hard. We generally try to provide a 1-2 page narrative description.

2. Language Matters. Many applicants unknowingly use language that has a specific meaning in tax-exempt organizations parlance. This can confuse the IRS and generate long lists of questions that may not apply, but nevertheless must be responded to. For example, there are strict rules that govern whether scientific

research is “in the public interest” or “commercial.” Statements that the organization conducts “research” are likely to trigger a list of questions pertaining to scientific research. The terms “advocacy,” “partnership,” “political,” and “publishing” can cause similar confusion.

3. Ancillary Documents. Often, the IRS will ask applicants to provide various contracts, grant applications and agreements, scholarship applications and guidelines, cost sharing agreements, and other evidence supporting the applicant’s plans. We have found that preparing and submitting drafts of the documents the planned activities call for can streamline the process significantly.

4. Timing. The IRS has a process to screen applications. Applications the screener finds raise no issues are processed within a few weeks to a few months. If the IRS screener has any issues or concerns, the application is assigned to a specialist for review. It typically takes 4 to 5 months for the file to be assigned to a specialist. Once a file has been assigned, we usually receive follow-up questions within a few weeks. The time required to resolve follow-up questions depends upon the complexity of the issues and the experience and training of the specialist.

5. Expedited Processing. It is possible to request expedited processing of the application in cases where the applicant has been offered a grant that will lapse if the entity does not provide the funder with a favorable determination letter by a specific date.

6. Interim Fundraising. Until the new charity receives its determination letter, it should disclose to potential donors that an application for 501(c)(3) status is pending. If the application is filed within 27 months of the date of incorporation and is ultimately approved, the entity’s 501(c)(3) status will be retroactive to the date of incorporation. Donors who claim a charitable deduction before IRS issues its determination letter assume the risk that application will not be approved. Many non-profits work with a fiscal sponsor during its start-up period to ensure their donors that their contributions will be deductible.

7. Cyber Assistant. The IRS has announced its plan to unveil a new Form 1023 preparation program called “Cyber Assistant” some time during 2010. This new tool will guide applicants through the Form 1023, providing cover sheets for attachments, continuation sheets for lengthy responses, and relevant taxpayer education.

8. User Fees. The IRS charges user fees to file an application for exemption. These fees are scheduled to increase on January 3, 2010. Organizations whose gross receipts average less than \$10,000 per year currently pay \$350. This fee will increase to \$400. All others pay \$850. This fee will increase to \$850. When the Cyber Assistant becomes available later in 2010, applicants who use it will be eligible for a reduced user fee of only \$200.