



## **Starting a Nonprofit – Frequently Asked Questions**

### **Q. Are “nonprofit” and “tax-exempt” the same thing?**

**A.** No. A “nonprofit” is a type of corporation that is formed at the state level. “Nonprofit” and “not-for-profit” mean essentially the same thing; states use different terms, and some use other terms, such as “nonstock.”

“Tax-exempt” in this context refers to an entity (e.g., a nonprofit corporation) that the IRS has granted exemption from federal income tax.

### **Q. What is a 501(c)(3) organization?**

**A.** A 501(c)(3) organization is an entity (often a nonprofit corporation) “organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary or educational purposes, or to foster national or international amateur sports competition...or for the prevention of cruelty to children or animals” that has been granted exemption from federal income tax under Section 501(c)(3) of the Internal Revenue Code and may be eligible for exemption from state and local taxes.

Donors to 501(c)(3) organizations may take a tax deduction for their donations, an important tool when an organization is fundraising. Donations to other types of 501(c) organizations are generally not deductible as charitable contributions.

### **Q. Can our nonprofit organization make a profit?**

**A.** Yes. A nonprofit can make a profit, meaning it spends less money than it raises in a given year. Similarly, a nonprofit organization does not need to spend all of its funds in a year. It is often a good thing if there are funds to carry over to the next year’s budget or to put away as a reserve.

However, any such profits must be used by the nonprofit to further its mission. They cannot be paid out like dividends. A 501(c)(3) organization may not be organized and operated primarily to make a profit – its goals must be to serve some charitable, educational, religious, or similar public good.

### **Q. What organizations are automatically tax-exempt?**

**A.** Churches, including synagogues, temples, and mosques, their integrated auxiliaries, and public charities whose annual gross receipts are normally not more than \$5,000 are automatically tax-exempt.

However, such organizations often apply to the IRS in order to receive a “determination letter” from the IRS that evidences their tax-exempt status. The determination letter can be important because funders may request a copy to provide assurance that donations to the organization are tax deductible to the donor. It is also sometimes required to get state and local tax exemptions.

**Q. Does my organization need to have 501(c)(3) status to begin fundraising?**

**A.** No. You can begin fundraising at any time. In fact, it is often advisable to solicit funding sources before making the decision to seek 501(c)(3) status to get a sense of whether your organization will be sustainable.

However, without 501(c)(3) status, contributions made directly to your organization are not immediately tax deductible for the donor. That said, there are ways in which donors may be able to take tax deductions for their contributions.

If your organization's application for tax exemption is pending before the IRS, it is possible that a donor's contribution will be deemed tax deductible eventually. If your organization filed its application for tax exemption with the IRS within 27 months from the end of the month in which it was formed, tax exemption, once received, will be retroactive to the date of formation. If the application is filed after 27 months, tax exemption, once received, will be retroactive to the date that the application was filed. In other words, donors may be able to take deductions once your organization is granted 501(c)(3) status for contributions made during the interim period. Solicitations during the interim period should say that tax exemption is pending and donations may be deductible if tax exemption is received. Solicitations must say "if" because you cannot presume or represent that tax exemption is guaranteed.

Another way in which donors may take tax deductions before your organization has 501(c)(3) status is if your organization is fiscally sponsored by another 501(c)(3) organization such that donors make their contribution to the fiscal sponsor for the benefit of your organization (discussed below).

**Q. What is fiscal sponsorship?**

**A.** Fiscal sponsorship is an arrangement between a 501(c)(3) public charity (the "Sponsor") and a project (which may be a nonprofit corporation or other entity, or an individual or group of individuals) (the "Project"). In a fiscal sponsorship, the Sponsor receives and expends funds to advance the Project.

An important potential benefit of a fiscal sponsorship arrangement is that donors may make tax-deductible contributions to the Sponsor for the benefit of the Project. The Sponsor may not simply act as a pass-through, however. A legal fiscal sponsorship arrangement requires the Sponsor to retain discretion and control over how the funds are used.

The mission of the Project must fit within and further the Sponsor's mission, but need not be identical. For example, a mentoring program for at-risk youth could be sponsored by a social services agency that runs many programs for the same or similar population.

Sponsors often provide additional services to the Project, such as general administration, accounting, management, human resources, or fundraising. Sponsors sometimes request a fee for their services, which may be a percentage of funds raised. These and other terms that the parties agree upon should be set out in a written agreement.

**Q. If we pursue fiscal sponsorship and don't apply for tax exemption, should we incorporate?**

**A.** It depends. Often, it does make sense to incorporate because there are good reasons to form a separate entity to house the Project. Among other benefits, the corporate form limits the personal liability of the individuals involved and allows the new entity to enter into contracts, purchase insurance, and take other actions in its own name. However, there are significant legal and administrative responsibilities that come with forming a new corporation. For relatively short-term or low-risk activities, the work and expense of setting up and maintaining a new corporation may outweigh its benefits. Consulting a lawyer for advice regarding your specific circumstances is strongly recommended.

**Q. Can we form a 501(c)(3) organization to benefit one individual?**

**A.** No. A 501(c)(3) organization cannot exist just to benefit one individual or specifically designated individuals. It is not permitted even if the goals are laudable, like raising funds for a family with a child with cancer. Rather, a 501(c)(3) organization's mission could be to raise funds for families of children with cancer generally with objective criteria for choosing recipients of the funds.

**Q. How long does it take to incorporate and get tax exemption?**

**A.** It depends. The process of incorporating varies depending on factors such as how long it takes the organization to draft the certificate of incorporation (called "articles of incorporation" in some states), the requirements and processing time in the state, whether expedited processing is available or requested, whether the state authority has follow-up questions after reviewing the certificate of incorporation, and whether any consents of other state agencies are required prior to filing the certificate of incorporation. The timeline can range from one day to months.

The time it takes to receive tax exemption varies depending on such factors as how long it takes the organization to prepare the application for tax-exempt status, whether the organization is using the Form 1023 or the shorter Form 1023-EZ (available to organizations that project annual gross receipts of \$50,000 or less in any of the next three years and meet certain other criteria), and whether the IRS has additional questions after reviewing the application. The timeline generally ranges from weeks to months.

**Q. Once my organization has 501(c)(3) status, is it exempt from state and local taxes?**

**A.** No. A 501(c)(3) organization is generally not automatically exempt from state and local taxes. After receiving federal tax exemption, a 501(c)(3) organization generally must apply for such exemptions with the appropriate taxing authority at the state or local level.

**Q. When do we need to register with the State Attorney General to solicit funds?**

**A.** Charitable solicitation laws vary from state to state, and not every state requires registration. In most states, an organization must register with the State Attorney General's office prior to beginning fundraising activities in that state. In Connecticut, registration with the state's Department of Consumer Protection is required. In New Jersey, registration with the state Division of Consumer Affairs is required once the nonprofit receives more than \$10,000 in donations. In New York, registration with the Charities Bureau of the New York State Office of the Attorney General is required prior to an organization's solicitation of contributions, or within six

months of the organization's receipt of any property or income required to be applied to charitable purposes, whichever is earlier.

Many states have exemptions from the registration requirements for small organizations and for organizations with specific charitable purposes. There may also be rules for specific types of fundraising, such as games of chance. It is important to check the rules in any state where your organization plans to fundraise before beginning fundraising activities.

**Q. What are bylaws?**

**A.** Bylaws are an internal operating manual for the board (and members, if any). They are particularly important to help the board of directors (referred to as the board of trustees in the New Jersey statute) govern effectively, and generally contain provisions on topics such as the roles of members (if any), directors and officers, elections, meetings, committees, conflicts of interest, basic financial matters, and the authority to hire a principal executive officer (often called a chief executive officer or an executive director).

Bylaws should generally be simple and flexible so that they are easy for the organization to comply with and are a helpful governance tool. It is a good idea to review them regularly to ensure that they reflect current operating practices, good governance practices, and compliance with the provisions of the certificate of incorporation and applicable state statute

**Q. What are “members,” are we required to have them, and do we want them?**

**A.** Members of a nonprofit corporation are in some ways analogous to shareholders of a for-profit corporation in that they generally play a role in governance, such as electing directors. The primary difference from shareholders is that members do not have a pecuniary (financial) interest in a nonprofit corporation.

The specific requirements related to having members vary by state. In most states the organization can elect whether or not to have members, which is documented in the organization's certificate of incorporation and/or bylaws. While having members makes sense for some organizations, often organizations choose not to have members, primarily for ease of administration. A formal membership structure should only be chosen if the organization has the type of mission and programs that would attract members who will be interested in participating in the nonprofit's governance and management. Many membership nonprofits whose members are entitled to vote find it hard to get members to attend meetings, often making it difficult for the nonprofit to operate effectively.

The members discussed here are different from members that some organizations have who are constituents and enjoy certain benefits but do not have governance rights (e.g., members of a museum who receive a newsletter and discounted admission).

**Q. How many board members must we have?**

**A.** State law generally requires a minimum number of board members (also referred to as “directors” in Connecticut and New York, or as “trustees” in New Jersey). Connecticut, New Jersey and New York require at least three board members.

The organization's corporate documents (generally the bylaws) specify the number, which is often greater than the minimum required and is sometimes a range (e.g., at least five and no more than 11).

**Q. How much responsibility do board members have?**

**A.** Board members have significant fiduciary duties and are ultimately responsible for the organization. It is critical that board members understand their responsibilities to lead the organization and recognize that they can be held liable in certain circumstances.

Board members may delegate responsibility for day-to-day management of the organization to a principal executive officer, but the board must exercise oversight as appropriate.

**Q. Can our principal executive officer serve on the organization's board of directors?**

**A.** Yes. It is permissible for a principal executive officer to serve on the board, as long as it is permitted by the organization's corporate documents (e.g., certificate of incorporation and/or bylaws).

It is strongly recommended that the organization have a conflict of interest policy to ensure that no director (including a principal executive officer serving on the board) participates in any votes on issues where the director, the director's relatives, or related entities stand to benefit. For example, principal executive officers should recuse themselves from board discussions of their salaries. New York requires all charitable nonprofit corporations to have a conflict of interest policy that meets certain legal requirements.

Some organizations choose to have a policy that the principal executive officer attends board meetings to keep the board apprised of programmatic developments but does not vote.

**Q. Can our founder be on the board forever?**

**A.** It is not recommended that anyone have an automatic right to be on the board forever, including the founder.

Many states, including Connecticut, New Jersey and New York, require that all members of the board be elected periodically. New York limits the length of a director's term to five years and, if there are staggered terms, the length may not exceed a number of years equal to the number of classes. Connecticut limits the length to one year, unless there are staggered terms in which case the length may be up to five years depending on the number of classes. New Jersey requires that trustees be elected at least every two years and, if there are staggered terms, the length of each term may be up to six years.

Connecticut, New Jersey, New York and many other states allow a board member to be re-elected without any limit on the number of terms served (if an organization does want term limits, they can be provided for in the bylaws). In this way it is possible for a founder to serve the organization for many years, but there is a periodic check on the person's performance.

Organizations and those serving on the board evolve over time, and it is not a good idea for the organization to be unable to make leadership changes. Oversight of the organization ultimately is the responsibility of the board (and voting members, if any), and it should have the ability to remove anyone, including the founder.

If a founder wants to be part of an organization forever, perhaps forming a nonprofit might not be the right route.

**Q. Can we have an advisory board?**

**A.** Yes. An organization can have an advisory board (or any other group of constituents), but everyone involved should recognize that such a group does not have legal rights and responsibilities that the board of directors has. It may be a good idea to have a charter for the advisory board that clearly defines its role and limits.

**Q. Can we pay our staff whatever we like?**

**A.** A 501(c)(3) organization cannot pay excessive compensation. Compensation must be “reasonable,” which is usually determined by looking at what people in similar positions at similar organizations earn.

**Q. Can board members provide services to the organization and be compensated?**

**A.** In the nonprofit sector, board members are rarely compensated for their services as board members. But board members can be compensated for other services to the organization as long as the transaction is on fair terms (or terms beneficial to the organization) and proper conflict of interest procedures are followed.

If such procedures are not followed and board members improperly benefit from transactions, they could be subject to fines or other consequences.

**Q. Do we have to file a tax return?**

**A.** Yes. All 501(c)(3) organizations must file some version of the Form 990 informational tax return annually. The type of Form 990 an organization files is determined by its annual gross receipts and total assets.

Form 990-EZ is a shorter version of the Form 990, and Form 990-N (or “e-Postcard”) is a filing that asks for very basic information.

The current thresholds are as follows:

	<b>Form to File</b>
Gross receipts normally $\leq$ \$50,000 (organizations eligible to file the 990-N may choose to file one of the longer returns)	990-N
Gross receipts < \$200,000, and Total assets < \$500,000	990-EZ or 990
Gross receipts $\geq$ \$200,000, or Total assets $\geq$ \$500,000	990

Returns are due on the 15<sup>th</sup> day of the fifth month after the end of the organization’s fiscal year (e.g., returns for an organization with a fiscal year end of December 31<sup>st</sup> are due the following

May 15<sup>th</sup>). Failure to timely file a Form 990 or Form 990-EZ can subject the organization to financial penalties, and failure to file any version of the Form 990 for three consecutive years will result in an automatic revocation of tax-exempt status.

**Q. Do we have to file an annual report with our state of incorporation?**

**A.** It depends on the state. For example, Connecticut requires a filing with the Secretary of the State and New Jersey requires a filing with the Department of the Treasury, Division of Revenue, but other states, like New York, do not have such a requirement. Any such report is in addition to an annual report that may need to be filed in order to solicit charitable donations in that state (discussed above).

**Q. Can a 501(c)(3) organization lobby?**

**A.** Yes. A 501(c)(3) organization can lobby (defined simply as taking a position on a bill or attempting to influence legislation), but the amount of lobbying is subject to a limit. The limit can be measured qualitatively (whether lobbying is a “substantial part” of the organization’s activities) or quantitatively (based on what the organization spends on lobbying).

An organization may elect how it would like its lobbying activities measured. Often, it is advisable to elect the quantitative measure (referred to as the “Section 501(h) election”) because the limit is clearer.

Lobbying is subject to complex rules, and in some cases, state and federal registration requirements.

**Q. Can a 501(c)(3) organization participate in political campaigns?**

**A.** No. A 501(c)(3) organization may not participate in political campaigns (defined simply as supporting or opposing a candidate for public office). Violation of this prohibition can lead to loss of the organization’s tax-exempt status. There are specific rules about what this prohibition means that a 501(c)(3) organization should understand, particularly around election time.

Board and staff members of an organization may participate in political campaigns in their individual capacity on their own time and without use of the nonprofit’s resources.

The organization can engage in issue advocacy or run a get-out-the-vote campaign, provided that it is not favoring any candidate or political party.

**Q. Can a politician serve on our organization’s board or attend one of our events?**

**A.** Yes. So long as the politician is clear that doing so is in the politician’s individual capacity, a politician can serve on an organization’s board or attend an event. If it is too challenging to make such a distinction, the organization may decide not to have the politician be involved.

If a politician running for office is invited to an event, the organization should consider inviting that person’s opponents as well so as not to appear to be endorsing a candidate.

**Q. What kind of insurance should our organization have?**

**A.** It depends on your organization’s activities (and, of course, its budget).

General liability insurance covers claims for bodily injury and property damage arising from accidents.

Directors and officers (“D&O”) insurance covers claims arising from the activities and decisions made by board members and officers in those capacities. Some people will require that an organization have D&O insurance before agreeing to serve on that organization’s board. Make sure that your D&O policy has employment practices liability (“EPL”) coverage if your organization has employees.

Activities such as child care, professional services, or food service may require additional or specialized coverage. It may also be appropriate for an organization to get insurance in connection with a particular special event or trip.

It is important for organizations to periodically perform a risk assessment to determine what types of policies are needed and the amount of coverage that is necessary to provide protection to the organization, board members, and officers. If possible, consult an insurance professional who is familiar with the needs of nonprofit organizations, and always be sure to understand what your policies cover.

---

This document is provided as a general informational service to volunteers, clients, and friends of Pro Bono Partnership, Inc. It should not be construed as, and does not constitute, legal advice on any specific matter, nor does distribution of this document create an attorney-client relationship.

Copyright 2023 Pro Bono Partnership, Inc. All rights reserved. No further use, copyright, dissemination, distribution, or publication is permitted without the express written consent of Pro Bono Partnership, Inc.

Revised July 2023.