

Leonard D. Easter, Esq  
29 Abruyn Street  
Kingston, NY 12401

845.338.7267 P  
646.349.1719 F  
845.706.5669 Mobile

[leonard.easter@gmail.com](mailto:leonard.easter@gmail.com) (preferred)  
[leondeaster@post.harvard.edu](mailto:leondeaster@post.harvard.edu)

Re:

Formation of a non-profit organization and tax exemption under section 501(c)(3) of the Internal Revenue Code.

Forming a nonprofit organization generally involves: legal formation; organization structure; tax exempt status (IRC section 501(c)(3) and various state and local exemption status recognition).

For purposes of this memo., I am dealing only with organizations seeking 501(c)(3) status, which is the most difficult exemption status to achieve. Other exemption status procedures (e.g. 501(c)(4)) present different degrees of difficulty. The main difference is that, generally, on a federal level, only 501(c)(3) status provides exemption to an organization for income as well as deductibility of qualified contributions to the exempt organization. So, in most circumstances, 501(c)(3) status is the most desired exempt status.

## LEGAL FORMATION

Incorporation: The recommended organizational structure is a nonprofit (or “not-for-profit”) corporation. This legal form of entity is generally created in strict adherence to state law. A corporate structure somewhat reduces the risks of “doing business” by conferring limited liability - separating possible liabilities between individuals/participants and the corporation itself. In general, a corporation separately remains liable for its own actions and such liability does not generally flow through to individuals or participants. However, there are responsibilities that attach to certain persons who are in a position to place the corporation in tenuous situations. Corporations have perpetual existence (with exceptions) and are subject to well defined laws in various jurisdictions.

The first step is the choice of a particular venue for the legal formation of the entity (incorporation). Some states are easier and less costly and other factors, such as location of board members, preferred site for operations/activities, etc. go into this geographic choice.

Some organizations elect to incorporate in Delaware because it is generally a corporate-friendly state. Delaware corporations are subject to a yearly resident agent and other periodic fees. Delaware corporations seeking to “do business” in other states may have to seek a separate permission to do business and officially appear in other jurisdictions, resulting in additional fees and expenses. In general, the choice of incorporation venue should be made after a careful determination of the propose organization’s projected activities and operations.

In order to qualify for eventual 501(c)(3) status, at least three persons are required for the initial board of directors - in some states (e.g. NY) they need not be US citizens but it is recommended that at least one board member be a US resident. for federal exemption purposes.

Generally, nonprofit corporations are formed as follows:

Proposed corporate name: The name of the corporation must be separate and distinct from other corporations located in the state, to prevent confusion and dilution. There is a clearance procedure to qualify a proposed name for use. Name choice is critical. It must not be misleading and should enhance the organization’s direction and image to the public (general branding concerns). It should serve as a rallying reference point for various proposed services and activities.

Board of Directors: At least three (3) natural persons, 18 years of age or over, serve as the initial board of directors. The number can be increased or decreased over time, respecting the 3 person minimum. Board meetings may be held in person, by written unanimous consent resolution, or by conference telephone call, or other electronic means.

Purpose clause: The purpose clause of the organization can be a generic statement that, in very general terms, indicates the charitable and/or educational nature of the corporation. This information is codified in a “certificate of incorporation” - the starting document for the entity which serves as the origin of the organization. This document may be subject to various state approvals - culminating with the approval and submission of the document with the Secretary of State. This purpose clause should be drafted in a manner that anticipates the projected, “exempt” activities and operations of the organization.

## ORGANIZATION STRUCTURE

After incorporation has been achieved, an initial meeting of the board of directors is completed, in which bylaws are adopted, officers are formally installed, ratification of the incorporation process and approval of the exemption application submission is achieved. This meeting is often held, “on paper” by unanimous consent resolution or by other allowable means (e.g. conference telephone call, etc.). In some cases, the single “incorporator” can adopt by laws and set forth the initial directors, subject to a subsequent organizational meeting of the directors,

## TAX EXEMPTION

The final step is the preparation of applications for exemption from applicable taxes, most notably, federal exemption recognition under section 501(c)(3) of the IRC. Under this recognition, related income received by the organization is exempt, and qualified contributions are deductible by the donor. The application for this exemption recognition is Form 1023 and requires significant and detailed information concerning the organization’s actual and proposed charitable/educational intent, activities and operations. This information is reviewed to determine, given stated objectives and proposed financial activity, whether an applicant is formed and operated to benefit the general public (“charitable/educational/etc”) rather than merely private individuals (“private inurement and private benefit) or concerns.

All fees and costs may vary and are generally subject to change.

The federal exemption process may be lengthy and often also subject to bureaucratic delays. However, in certain circumstances, expedited application handling can be requested (e.g. in cases of imminent funding or other special circumstances). Absent this request, the application process is usually from 90 days to 6 months.

Recently, the IRS has streamlined the application process for those organizations expecting initial gross yearly support less than \$50,000.00. Processing often takes several weeks.

## POST EXEMPTION

Once federal exemption is achieved, further exemptions are often sought. (for every tax, there is a process for exemption). Franchise tax, sales and use tax, etc. exemptions are easier obtained after a federal exempt status is achieved, In addition, various federal and state law registrations and reports are sometimes periodically required.

## OTHER CONCERNS

The above discussion is primarily concerned with new, proposed nonprofit entities seeking formal existence and resulting 501(c)(3) federal classification. There are instances in which a “program” or “project” that does not have a formal, separate existence but maintains programs, operations and directed activities, has a relationship with a “conduit” or “sponsor” organization that provides services, and its own 501(c)(3) designation for the receipt of deductible funds and eligible funding. Care must be exercised in these circumstances in order that an entity that seeks its own existence, does not create problems with the sponsor nor with the IRS. For example, a consistently run program may have taken on the guise of a separate organization, even in a sponsorship context (e.g. unincorporated association). An early discussion of the sponsorship relationship (there may be a contract, etc. that requires review for compliance) should be done respecting the separation.

However, these types of entities do not enjoy the aspect of limited liability protection that flows from the nature of a corporation. These choices may increase the amount of risk and possibility of individual/participant liability.

Respectfully submitted,

Leonard D. Easter