

So, You Want to Start a Nonprofit?

BY MICHAEL D. SCHLEY

You are likely, sometime in your career, to hear a client ask about starting a nonprofit. Here are some initial considerations that may help you steer your client in the right direction.

What are the Types of Nonprofits?

Federal and California laws define many categories of nonprofit entities.

Nonprofits organized in California can generally be only a corporation or a trust. There are different types of nonprofit corporations, the main ones being nonprofit public benefit corporations (such as your typical charity), mutual benefit corporations (such as chambers of commerce), and religious corporations. There are many others, but these are the main types.

Your client might be familiar with limited liability companies and ask whether the new nonprofit can be an LLC. The answer is no, at least not a California LLC. At least, not for now. There are new forms of hybrid corporations that serve both shareholder and public purposes, but they are beyond the scope of this article.

California tax laws, administered by the Franchise Tax Board (FTB), and federal tax laws, administered by the IRS, recognize at least 28 types of nonprofits. These include homeowners' associations, cemetery companies, political organizations, mutual insurance companies, and veterans' organizations, to name just a few.

What is a Public Charity?

Usually the inquiring client will have in mind a "public charity." This is a nonprofit public benefit corporation, or a trust, dedicated to charitable, public, or educational purposes. Its tax exemption is based on Internal Revenue Code § 501(c)(3) and Cal. Rev. & Taxation Code § 23701d. For the remainder of this article, we will assume that the client wants to form a public charity organized as a California nonprofit public benefit corporation.

The "public" in "public charity" means that the organiza-

tion meets one of several tests indicating it receives broad public support or that it is dedicated to supporting another public charity or a government institution. A nonprofit is presumed to be a "private foundation" (supported and controlled by one donor or a group of donors) unless it proves it is a public charity.

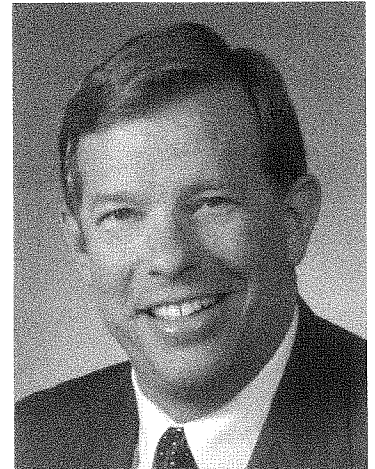
Why is public charity status important? Private foundations must pay certain taxes and have higher compliance costs and tighter conflict-of-interest rules. Also, private foundations cannot give money to your client's charity if it is also a private foundation. Thus, your client must consider carefully whether there will be public sources of funding for the proposed nonprofit, to qualify as a public charity.

Is there a nonprofit purpose?

This may seem like too basic a question, but it is easily overlooked at great peril to the client.

The first inquiry is whether the client's intended activity truly fits within state and federal definitions of nonprofit purposes. For example, an environmental project to identify producers and buyers of sustainably caught seafood might seem, to the IRS examiner, to be more for commercial than charitable purposes. There is a large body of IRS precedent regarding what is and what is not a permissible nonprofit purpose. Front-end research to verify that your client's purpose qualifies is a wise investment to help you prepare a stronger exemption application or to help your client avoid a waste of time and resources.

A second inquiry is whether the proposed charity will impermissibly serve private interests. More than once I have heard a client describe a charitable project, only to realize after questioning that the client had plans for impermissible transactions or arrangements between the charity and the client's business interests. Impermissible private interests can take the form of high-rent leases, service or purchase contracts on unfair terms, or unreasonable compensation to insiders of the charity, as examples. Any arrangements or transactions with related parties will be scrutinized by the IRS, and should be carefully vetted in advance by counsel.



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What is the process?

The main steps in organizing the public charity and obtaining tax-exempt status are:

Organizing the corporation. If you have formed a business corporation, most of the tasks and issues involved in forming a nonprofit public benefit corporation will look familiar, though many rules are different. The starting point of forming the charity is to incorporate and then have the founding board of directors take appropriate organizational actions, including adoption of bylaws and appointment of officers. Your client cannot wait until he or she has an approved charity before organizing the first board.

Registering with the Attorney General (AG). Almost all public charities operating in California must register with the AG's Registry of Charitable Trusts. The AG enforces many laws governing California charities and their fundraising activities. This relatively simple registration must be done promptly after receiving the first asset donation (usually, the opening of a bank account) and is often overlooked by do-it-yourself organizers.

IRS tax exemption. A public charity applies on IRS Form 1023 for a determination letter recognizing its tax-exempt status. This is a fairly detailed application with many supporting exhibits. An experienced professional adviser will know which information is critical and which information, if not carefully and accurately written, will create "red flags" in the IRS review process.

California tax exemption. California's tax exemption process formerly involved a similar, lengthy application (FTB Form 3500) and a substantial review process. Your client will be pleased to learn that legislation promoted by the State Bar's nonprofits committee eliminated this process a few years ago. Under our new law, your client will submit a copy of the IRS determination letter attached to Form 3500A (just two pages), and the FTB approval is automatic.

Clients always ask, "How long will this take?"

The *technical* answer is: Preparation of corporate documents, AG registration, and the Form 1023 application can be done quickly; IRS review of the application and issuance of the determination letter can take from 3-6 months for a routine review and 18-24 months for an application posing more complex issues for the IRS. Furthermore, average review times have fluctuated greatly over the past several years, and are likely to lengthen if IRS staffing is reduced when budgets are tight.

Most clients need to be advised that the "client steps" can take far longer than the "legal steps." It can take months for your client to identify qualified individuals who are willing to serve on the first board. After that, the board members

might take additional months making decisions about organizational appointments and documents and corporate policies and plans, decisions that must be made before the Form 1023 application can be filed. Clients often find the preparation of a financial projection daunting, even though the charity will not be strictly held to it by the IRS. Thus, it is very hard to predict the timeframe for project completion, because much depends on the efforts of your client and the first board.

Practical Advice

Your client should hear this practical advice before making a decision:

There are other options. It might make sense for your client to operate as part of an existing nonprofit, without adding to the multitude of local charities.

Or, especially where your client's concept is not yet proved, your client might wish to first take a test drive, known in the nonprofit world as "fiscal sponsorship." It works like this: Your client enters into an agreement with an existing nonprofit with a mission that encompasses your client's project. Your client pursues the project under the auspices and supervision of the existing nonprofit. If it is a success, the fiscal sponsorship agreement you negotiated for your client will permit him or her to transfer the project to a newly established public charity.

It is impossible to form your own charity. Many clients think that they can establish a nonprofit and control it indefinitely. You must disabuse them of this notion. A public charity will have a board of directors. Even though your client might hand-pick the initial board, there is no assurance that the same individuals, or their successors, will allow your client to continue to manage the charity, or even participate as a director or volunteer. It is a normal part of a charity's lifecycle to part ways with its founder(s).

So, does your client *still* want to start a nonprofit? Armed with this information, he or she can do it more quickly and efficiently, and devote more resources to good charitable works. ■

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