

SETTING UP YOUR 501(C)(3) NONPROFIT ORGANIZATION

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Relevant Experience:

- Co-author, Governance of Nonprofit Organizations, presented at University of Texas Nonprofit Organizations Institute, January 12-14, 2011
- Co-author, Governing Documents: Certificates of Formation, Bylaws and More, presented at 2010 State Bar of Texas Governance of Nonprofit Organizations Course, August 19-20, 2010
- Co-author and Co-presenter, Running Public Charities and Private Foundations, presented at 2010 Texas Society of CPAs -Fort Worth Chapter Nonprofit Organizations Conference, January 26, 2010
- Presenter, Need to Know: Arts Administration - Fiscal Organizational Review, presented to Arts Council of Fort Worth & Tarrant County, January 11, 2010
- Author, Fiduciary Duties in Investing Charitable Assets (presented at State Bar of Texas, Governance of Nonprofit Organizations Course (2009) and for the Dallas Nonprofit Study Group at Belo Mansion September 16, 2009)
- Author and Presenter, Policies for Tax-Exempt Organizations, presented to Texas Society of CPAs - Fort Worth Chapter, October 27, 2009
- Author, Fiduciary Duties: Non-profits and Charitable Trusts, presented to National Trust Closely Held Business Association, September 3, 2009
- Co-author, Charitable Lead Trusts, ALI-ABA Estate Planning Course Materials Journal (February 2009)
- Co-author and co-presenter, Governance in the World of Family Foundations, State Bar of Texas, Governance of Nonprofit Organizations Course (2008)

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SETTING UP YOUR 501(C)(3) NONPROFIT ORGANIZATION

I. INTRODUCTION

“I have an idea for a new organization. Should I set up this organization as a 501(c)(3), and if so, what does that entail?” This paper is meant to address those questions and provide practical assistance in the procedure of gaining recognition of federal tax exemption.

As with most undertakings in life, there are both benefits and detriments to deciding to seek qualification as a 501(c)(3) organization. The obvious benefits include exemption from federal income tax (and concomitantly certain state taxes as well) and the ability for donors to receive deductions for donations given on their personal income tax returns. Additionally, many organizations that will seek funding from grant-making foundations find it beneficial to gain recognition of exemption under § 501(c)(3) of the Internal Revenue Code (the “I.R.C.”). Balanced against these benefits are detriments, the most significant being prohibition against 501(c)(3) organizations distributing profits to owners. In addition, 501(c)(3)s are prohibited from engaging in certain activities which are contrary to the requirements for exemption under § 501(c)(3) such as substantial efforts to influence legislation or intervention or participation in political campaigns. Because the intended focus of this paper is the procedure for gaining the recognition of exemption as a 501(c)(3) organization, the paper will assume that the answer to the first question is “yes, I want to seek exemption under § 501(c)(3).”

II. DETERMINING THE PURPOSE(S)

Section 501(c) of the I.R.C. contains a list of organizations qualifying as exempt organizations. Of the twenty-seven categories of exempt organizations listed under § 501(c), 501(c)(3) is but one. However, the vast majority of all exempt organizations are exempt under § 501(c)(3). At the outset it is helpful to quote directly the description of a 501(c)(3) organization from the I.R.C. It is as follows:

Corporations and any community chest, fund, or foundation 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 (but only if no part of its

activities involve the provisions of athletic facilities or equipment), or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual, no substantial part of the activities of which is carrying on propaganda or otherwise attempting to influence legislation (except as otherwise provided in subsection (h)) in any political campaign on behalf of (or in opposition to) any candidate for public office.

Because the I.R.C. defines an organization eligible for exemption under § 501(c)(3) by its purposes, the first decision that must be made is whether your organization has a nonprofit purpose that fits within the categories listed in § 501(c)(3). It should further be noted that to constitute a legitimate purpose, the purpose must be legal. For example, it may be educational to instruct college students on the methods and means of organized protest, but to the extent an organization seeks to qualify as a tax exempt organization, it cannot be teaching those same college students the methods of performing illegal protests.

Once an exempt purpose is identified, the organization must be organized “exclusively” for that exempt purpose. The Treasury Regulations state that an organization is organized exclusively for one or more exempt purposes only when the organization’s enabling document (such as articles of incorporation) limit the purposes of the organization to those exempt purposes. Treas. Reg. 1.501(c)(3)-(1)(b)(1)(i). The Service has provided language to satisfy the organizational test that can be found in Publication 557 available at www.irs.gov.

III. CHOOSING THE VEHICLE

Once it is determined that the organization has a nonprofit purpose that fits within the categories described in § 501(c)(3), the organizer must next determine the choice of entity to use for the organization. The Internal Revenue Service (the “Service”) recognizes three types of entities eligible for exemption under § 501(c)(3): (1) a charitable trust, (2) a nonprofit unincorporated association, and (3) a nonprofit corporation. Each of these three types of entities has unique characteristics and pros and cons to use.

A. Charitable Trusts

Charitable trusts are the oldest type of nonprofit entity tracing their roots back to the Statute of Charitable Uses of 1601. 43 Elizabeth, Chapter 4 (England 1601). A charitable trust is created by a settlor irrevocably transferring property to a person or entity as trustee with the intention of creating a charitable trust. Charitable trusts created in Texas are governed by the Texas Trust Code as well as common law relating to trusts and are subject to the oversight authority of the Texas Attorney General.

Aside from the benefit of having many years of established case law, many founders choose charitable trusts as the organizational form of their entity because of the rigidity of trusts. A settlor is able to establish the trust with specific purposes and be assured that the trust will operate for those purposes absent court intervention. The settlor also has the security of knowing the trustee(s) will be held to higher fiduciary standards in performing his or her duties.

While the rigidity of trusts can be viewed as a benefit, that same feature may be viewed as inflexibility and thus may be viewed as a detriment to others looking to choose an entity. The ability to modify a trust requires court intervention and is not automatic. Trustees are more limited as to their investments as well as their ability to delegate duties. Trustees are additionally subject to more stringent conflict of interest and self-dealing prohibitions and must meet a higher standard for indemnification as compared to directors of unincorporated associations or nonprofit corporations.

B. Unincorporated Associations

Nonprofit unincorporated associations are the default nonprofit organization. Texas defines a nonprofit unincorporated association as an unincorporated organization, other than one created by a trust, consisting of three or more members joined by mutual consent for a common, nonprofit purpose. *See* Tex. Bus. Orgs. Code Ann. § 252.001 et seq. Formation of an unincorporated association is not governed by statute and does not require any organizational documents although an unincorporated association will typically have articles of association, a constitution, or bylaws. The existence of an unincorporated association in Texas is governed by Chapter 252 of the Texas Business Organizations Code (“TBOC”). The statute clarifies that an unincorporated association is a separate legal entity from its members with powers to promote the aims and purposes of the organization and advance the members interests by all legitimate and legal means. Unincorporated

associations have the right to sue or be sued, sue or be sued by a member, acquire, hold, encumber, transfer real or personal property without the need for trustees, be a beneficiary of a trust, contract, will, or policy of life insurance, apply for property tax exemption, and apply for federal tax exemption under § 501(c)(3). The Service has acknowledged that a typical nonprofit unincorporated association will be treated as a corporation (recall that § 501(c)(3) speaks to corporations) when it is formed under a contract or bylaws and has elective officers empowered to act for the association. It should be noted that the Service will expect to see some type of governing document such as articles of association, with certain provisions regarding organization, operation and dissolution of the association in order to qualify for 501(c)(3) status. These provisions will be discussed more fully below.

Benefits of operating as an unincorporated association relate to the informality of such an entity. Unincorporated associations are relatively easy to establish as they simply require three or more members joining by mutual consent for a common, nonprofit purpose. In addition, unincorporated associations are internally as flexible as the founders desire. Finally, unincorporated associations have the ability to rely on statutory authority in Texas to assure that they are recognized as separate legal entities such that members do not have personal liability in tort or contract absent special circumstances.

On the contrary, there are numerous drawbacks to organizing as an unincorporated association. First and foremost, while Texas has adopted Chapter 252 of the TBOC (which was derived from the Uniform Unincorporated Nonprofit Association Act, only in place since 1995), the new statute has only been in place since 2006. As such, there is very little case law interpreting either Chapter 252 or the Act, leaving an element of the unknown. Second, because unincorporated associations are so flexible, a founder has less assurance that his or her wishes as to the direction and purposes of the organization will remain unchanged. Finally, many unincorporated associations find they have trouble with potential lenders who are more comfortable dealing with corporations than with unincorporated associations. Practically speaking, for an unincorporated association to qualify for federal tax exemption under § 501(c)(3) (which is, after all, the purpose of this paper) the unincorporated association must make itself look and act quite a bit like a nonprofit corporation through adoption of a governing instrument with the requisite provisions for exemption.

C. Nonprofit Corporations

The final entity eligible for exemption under § 501(c)(3) is a nonprofit corporation. Nonprofit corporations in Texas are governed by Chapter 22 of the TBOC. *See* Tex. Bus. Orgs. Code Ann § 22.001 et. seq. The TBOC defines a nonprofit corporation as a corporation no part of the income of which is distributable to a member, director or officer of the corporation. *See id.* at §22.001(5). It is helpful to note here that income may be distributed to individuals performing services on behalf of the corporation in the form of salary as long as those salaries are reasonable and commensurate with the services rendered. Nonprofit corporations in Texas may be organized for any lawful purpose, but keep in mind that to qualify under § 501(c)(3) the corporation must be organized with a purpose identified in § 501(c)(3) (e.g. religious, charitable, educational, etc.). Pursuant to Chapters 2 and 22 of the TBOC, nonprofit corporations have the ability to perpetually exist, to sue and be sued in their corporate name, purchase, lease, or own property in the corporate name, lend money (so long as the loan is not made to a director), contract, make donations for the public welfare, and exercise other powers consistent with their purposes. *See* Tex. Bus. Orgs. Code Ann. §§ 2.001-002, 2.101-102, 3.003 and 22.054. While having extensive powers, nonprofit corporations remain internally flexible with the power to amend their operations and purposes through board (or member) action. Whereas unincorporated associations lack extensive statutory guidelines and case law guidance, nonprofit corporations in Texas have Chapter 22 and its predecessor, the Texas Non-Profit Corporation Act, with extensive case law interpreting it, as well as the ability to analogize to for profit corporate law.

There are very few drawbacks to organizing as a nonprofit corporation, particularly when the organization will be seeking federal tax exemption under § 501(c)(3); however, those drawbacks are not major roadblocks. While establishing and maintaining a nonprofit corporation does require more work (and therefore more expense) as compared to an unincorporated association, the same work will have to be done for an unincorporated association in the event that it is seeking federal tax exemption. Furthermore, while a nonprofit corporation is subject to the Texas franchise tax, an exemption under § 501(c)(3) from federal income tax qualifies the organization for exemption from the franchise tax as well. Finally, many of the various rules that are required for nonprofit corporations applying for exemption such as specific dissolution clauses and the like are a requirement for any organization seeking exemption under § 501(c)(3). Unless an organizer wishes to set

up a 501(c)(3) entity as a charitable trust to take advantage of the specific characteristics and benefits of such an entity, it is generally most beneficial to organize as a nonprofit corporation and thereafter seek exemption under § 501(c)(3).

D. Considerations in Choosing an Entity Structure

Ultimately, there are several considerations that should be taken into account in determining the choice of entity. These considerations include how quickly the founder wishes to establish the entity, the founder's level of concern over liability exposure, the sophistication level and goals of the founder, the financial resources of the organizers, the type and scale of activities to be conducted by the organization, the type of governance structure desired, and the duties to be imposed on the directors/trustees in operating the organization. The remainder of this paper will assume the organizers have chosen a nonprofit corporation for the structure of their entity.

IV. FORMING THE ENTITY

A. The Organizational Documents

Once the choice of entity has been made, the next step is to form the entity. In Texas a nonprofit corporation is formed by filing the certificate of formation with the Texas Secretary of State. The certificate of formation will include the name of the corporation (an obvious decision that must be made by the founder), a statement that the corporation is to be nonprofit and a statement of nonprofit purpose (e.g. religious, charitable, or educational), the period of duration (which may be perpetual), whether the corporation is to have members, whether management is to be vested in the members (rather than a board of directors), the name of a registered agent, the street address of the registered office, the names and addresses of the initial board of directors which must number at least three (assuming that the organization is not a member led organization without a board of directors, such as a congregationally-led church), the name and address of each organizer, a dissolution clause directing that upon dissolution the assets of the corporation will be transferred to another exempt organization (or if the corporation is to be authorized on winding up to distribute assets in a manner other than as provided by Section 22.304, a statement describing the manner of distribution), and any other provision not inconsistent with law such as indemnification of directors, provision governing amendments, etc. *See* Tex. Bus. Orgs. Code Ann. §§ 3.005, 3.009. Once the certificate of formation is

prepared, it should be filed with the Secretary of State, along with a nominal filing fee (currently \$25 for regular service and \$50 for expedited service). *See id.* at § 4.153. The Secretary of State, upon approval of the certificate of formation, will accept the certificate into its filing system and issue a written acknowledgment of filing to the entity or its representative. *See id.* at §4.002(a)(1)-(2). The beginning date for the corporate existence of the corporation is the date when the certificate of formation is filed with the Secretary of State (assuming there is no delayed effectiveness provision in the certificate). *See id.* at §§ 3.001 and 4.051. Issuance of a certificate of filing is conclusive evidence of the entity's existence. *See id.* at § 4.005

B. The Organizational Meeting

Once the corporation receives its certificate of incorporation from the Secretary of State, the corporation should hold its initial organizational meeting at which the corporation will adopt bylaws, appoint directors and officers (noting that the same person cannot serve as both president and secretary of the corporation), authorize establishment of bank accounts in the name of the organization, and authorize the organization to take the necessary steps to seek recognition of exemption under § 501(c)(3). The organization should also file a Form SS-4, Application for Employer Identification Number, at this point with the Service to obtain a federal tax identification number. Once the steps identified above have been taken, the organization exists as a Texas nonprofit corporation with the ability to begin operations; however, it does not yet have recognition of its federal tax exemption under § 501(c)(3), and it has not yet been recognized as exempt from the Texas Franchise Tax. Therefore, the next step is seeking recognition of exemption.

V. OBTAINING RECOGNITION UNDER § 501(C)(3)

Congress, in the Tax Reform Act of 1969, added § 508 to the Internal Revenue Code thereby mandating that organizations formed after October 9, 1969, with certain exceptions (such as churches) which will not be discussed in this paper, apply for recognition of exemption under § 501(c)(3). The Service thereafter created Form 1023, Application for Recognition for Exemption Under Section 501(c)(3) for that purpose.

Form 1023 can be downloaded from the Service's website (www.irs.gov). Form 1023 consists of approximately ten (10) pages with approximately twenty (20) additional pages of schedules and

instructions. While the form may initially appear daunting, it is less so when taken in bite-size pieces.

A. Elements of a Substantially Complete Form 1023

A substantially complete Form 1023 contains the following:

1. The signature of an authorized individual;
2. The organization's employer identification number or a completed Form SS-4;
3. Information concerning previously filed federal income tax and exempt organization returns;
4. A statement of receipt and expenditures and a balance sheet for the current year and the three preceding years (or for the number of years of the organization's existence, if less than four years) [Note: If the organization has not yet commenced operations or completed one accounting period, financial data for the current year and proposed budgets for the next two accounting periods are sufficient.];
5. A statement of actual and proposed activities, Treas.Reg. §1.501(a)-1(b)(2)(iii), and a description of anticipated receipts and contemplated expenditures;
6. A copy of the articles of incorporation, trust indenture or other organizational or enabling document signed by a principal officer or accompanied by a written declaration signed by an authorized individual certifying that the document is a complete and accurate copy of the original [Note: Any originals submitted will become part of the file and will not be returned.];
7. If the organization is a corporation or unincorporated association which has adopted bylaws, a current copy thereof;
8. Form 2848, Power of Attorney and Declaration of Representative, if applicable;
9. Form 8718, User Fee for Exempt Organization Determination letter request, and a check made payable to the IRS in payment of the user fee applicable to the organization. Revenue Procedure 2011, 2011-1 I.R.B. 237, § 6.07 sets the user fee at \$850 for initial applications for exempt status for organizations seeking exemption under I.R.C. § 501(c) whose actual or anticipated gross receipts exceed \$10,000. Applications for exempt status of organizations (other than pension and profit sharing plans) that have had annual gross receipts averaging

not more than \$10,000 during the preceding four years, or new organizations anticipating gross receipts averaging not more than \$10,000 during their first four years, must pay a user fee of \$400. If the organization does not include the correct user fee with the application, the application will be returned.

B. Practical Advice on Completing the Form 1023

Part I of the 1023 requests information about the organization including basic information such as the name, EIN (if no EIN has been obtained, state “Applying” and attach a completed SS-4), the contact person for the organization in the event of questions regarding the 1023 (typically the person completing the application), the fiscal year end for the organization, and the address of the organization. If the organization has a website, the address will need to be listed. [Note: The Service will typically ask for a hard copy of all pages of a website.] The date the organization was incorporated or formed will be the date on the Certificate of Incorporation for nonprofit corporations. Questions 7-10 and 12 should be answered “yes” or “no” depending on the circumstances of the organization. Most organizations will answer “no” to question 10 regarding exceptions to filing Form 990 (exceptions include churches, associations of churches and integrated auxiliaries of churches). Specific instructions for Form 990 are available.

Part II asks about the entity’s organizational structure. Note that a conformed copy of the organizing documents must be attached (e.g., trust indenture, articles of incorporation, articles of association). It is helpful to refer to exhibits at this point, attaching articles of incorporation/certificate of incorporation as Exhibit A and bylaws as Exhibit B.

Part III requests the applicant to confirm that its organizing document contains a description of its exempt purposes in order to meet the organizational test under Section 501(c)(3). Additionally, the applicant must confirm that its organizing document contains an appropriate dissolution clause. Both provisions must be specified. Care should be taken in drafting the organizing document to ensure these requirements are met, particularly where an applicant is using the forms available on the Texas Secretary of State website which do not contain such provisions by default.

Part IV of Form 1023 seeks information regarding the activities and operations of the organization. Part IV is arguably the most important section on the 1023 for the applicant and care should

be taken in answering it. This question asks for a detailed narrative description of the activities of the organization. It is often helpful to refer to and attach a word-processed document for this answer thereby allowing the applicant the ability to truly “draft” a response. Additionally, brochures, pamphlets, and other information may be included here. The answer should include as much detail as possible particularly for private operating foundations and public charities who carry on their own activities. The Service often requests additional information with respect to this question so it is always best to be as complete as possible in the initial answer to prevent delay. The applicant should be mindful that, once approved, the 1023 is open to public inspection. This section is a critical area to present the organization’s activities both to the Service and the public.

Part V of the Form 1023 addresses compensation and other financial arrangements with officers, directors, and trustees, along with employees and independent contractors who receive more than \$50,000.00 per year. The form asks for names, titles, addresses, and the compensation for such individuals. It should be noted that nonprofit directors are typically uncompensated and the Service will give more scrutiny to compensated directors. Where individuals serving as directors are also serving as officers and/or employees and are being compensated for such latter roles, that distinction should be made. This is not to say that federal tax law prohibits directors from being compensated, but rather to point out that it is less common. It is helpful to identify what services the individuals are providing to be entitled to the compensation and to confirm that the organization understands that all salaries that are paid or will be paid in the future will be reasonable and commensurate with the services rendered. This response can be included on an attached exhibit.

The remainder of the questions in Part V explore conflicts of interest. These questions ask whether the governing body and other highly compensated employees or independent contractors are related to each other by family or business relationships, and asks for those relationships to be identified and explained. In addition, the questions ask for confirmation that compensation will be reasonable, and if a written conflict of interest policy is not followed with respect to compensation decisions, how it will be determined that compensation decisions are reasonable. Again, because this is an application making representations to the Service which will also be open to the public, the applicant should be aware that should it answer yes to these questions (which is the typical course) it must also abide by these representations (e.g. following a conflict of interest

policy, approving compensation arrangements in advance, etc.). Question 5 inquires whether the organization has a conflict of interest policy consistent with the Service's sample policy. The organization should answer yes or no as appropriate but understand that if it does not have such a policy, further information will need to be provided to demonstrate how the organization protects against inappropriate conflicts of interest. If a conflict of interest policy has been adopted, the organization should attach that policy. It is typical for the Service to require that the policy be signed by all of the governing board or have been adopted at a meeting or by use of a consent whereby all of the governing board have indicated their acquiescence to the policy.

The remainder of Part V explores other ways in which the members of the governing body or highest compensated employees or independent contractors might receive monies from the organization such as through non-fixed payments (discretionary bonuses or revenue-based payments), through selling goods, services, or assets to the organization, or through leases, contracts, loans, or other agreements. These types of relationships, if they are in existence or are anticipated, should be addressed and explained on an attachment. Aside from a private foundation which must abide by the prohibition on self-dealing, these types of arrangements are not absolutely prohibited, but the applicant must demonstrate that it has appropriate safeguards in place to ensure that the terms are, or will be, negotiated at arm's length and that the organization will pay no more than fair market value or fair rental value. In essence, this section seeks to explore areas where the organization is susceptible to being taken advantage of by insiders (i.e. private inurement situations) and to ensure that the organization understands those areas and has appropriate mechanisms in place to avoid inappropriate conduct in such areas.

Part VI seeks information related to the goods, services, and funds that the organization provides to individuals and organizations as a part of its exempt activities. Again, the applicant should check either yes or no as appropriate. For example, Part VI, Question 1a should be checked yes if the applicant provides goods, services, or funds to individuals while Question 1b applies to goods, services, or funds being provided to organizations. It may be that the applicant provides goods, services, or funds to both individuals and organizations in which event both boxes would be checked yes. Likewise, at Question 2, if goods, services, or funds are limited to a specific group of individuals, this is the area where the applicant would identify that group. For example, if the applicant is a scholarship-making foundation, the applicant would

identify, as appropriate, the specific group (such as graduates of a specific school) who would be eligible for such scholarships. Finally, Question 3 of Part VI inquires whether any of the individuals who receive goods, services, or funds from the organization have a family or business relationship with any of the governing body, highly compensated employees or highly compensated independent contractors. As with other sections on the form, where the applicant answers yes to this question, additional explanation should be provided. This additional explanation should again explain how the organization will safeguard against the organization's assets being used to unduly benefit insiders or their family or business relations. It should be noted that in responding to the questions at Part VI, it is not necessary to repeat information that was provided at Part IV with regard to the activities of the organization. Rather, it is sufficient to cross-reference to Part IV where Part IV has given a full and complete description of such activities and the intended beneficiaries of those activities.

Part VII inquires about the history of the organization. If the organization is a successor to another organization (having taken over 25% or more of the fair market value of the net assets of another organization or established upon the conversion of an organization from for-profit to nonprofit status), the organization should check yes and complete Schedule G which seeks further information about such predecessor-in-interest organization. Part VII, Line 2 is the area where the organization confirms that it is filing its Form 1023 within 27 months of having filed its certificate of formation. As addressed in Section V.D., *supra* an organization that files within 27 months of its date of incorporation is deemed to have "timely" filed. When an organization has filed after that time, it must complete Schedule E to the Form 1023.

Part VIII asks additional questions about the specific activities of the organization. Question 1 asks whether the organization supports or opposes candidates in political campaigns. This question should be answered no as Section 501(c)(3) prohibits supporting or opposing candidates in campaigns for elected public office by Section 501(c)(3) organizations. Question 2 asks about the organization's efforts to influence legislation. If the organization does make such efforts, those should be detailed here. Organizations that attempt to influence legislation should consider filing Form 5768 to make an election under Section 501(h) to demonstrate that its legislative activities comes within appropriate safe harbor. If such election is made, the applicant would indicate this at Part VIII, Line 2b and attach a copy of the Form 5768. The remaining questions in Part VIII will be answered differently depending on the organization. Where the

organization answers yes to any of these questions, additional information should be provided. Particular care should be given to the answers in Part VIII as these answers inquire into activities of interest to the Service. A “yes” answer should be fully explained with an understanding that the Service will be looking at these explanations to determine whether the organization plans to operate in a way that meets the operational test under Section 501(c)(3).

Questions 12 and 14 of Part VIII inquire about operations in foreign countries as well as grants, loans, or other distributions to foreign organizations. An applicant that plans to have foreign activities should take particular care to understand the rules that apply to operating in foreign countries and making cross-boarder grants including an understanding of anti-terrorism measures such as Executive Order 13224, the Patriot Act, and the Treasury Anti-Terrorist Financing Guidelines. Those particular rules are beyond the scope of this paper.

Part IX requests financial data about the applicant. This section seeks financial information about the organization for each of the 3 preceding years, or, if the organization has been in existence for less than 1 year, for the current year along with proposed budgets for the following 2 years. Again, it is often easiest to refer to attached exhibits and attach spreadsheets from the organization showing the requisite financial data. Care should be taken to ensure that the financial projections for newly-formed organizations are reasonable and demonstrate that the organization will operate for its exempt activities. Further, with respect to private foundations, organizations which are subject to a minimum distribution requirement, care should be taken to ensure that the projections show that the minimum distribution requirement will be met.

Part X inquires as to whether the organization is a private foundation or a public charity. A nonprofit organization is presumed to be a private foundation unless it demonstrates it fits an exception to such rule as a traditional public charity, a publicly supported public charity, a supporting organization, or an organized and operated exclusively to test for public safety. If the organization is a private foundation, Question 1b of Part X requires that the organization confirm that its organizing document meet requirements of Section 508(e) with respect to special provisions applicable to private foundations. Likewise, if the organization is a private foundation, it will need to answer Question 2 of Part X which inquires into whether it is a private operating foundation as opposed to a private non-operating foundation. An organization that is seeking to be classified as a public charity will

go directly to Question 5 and indicate its basis for being treated as a public charity.

When the revised Form 1023 was first developed in June 2006, Part X, Line 6 was to be filled out in the event that the organization indicated it was a public charity on the basis of being a publicly supported organization. Under those circumstances, the organization was required to determine whether it wished to seek an advanced ruling of its public charity status. However, the IRS subsequently eliminated the advance ruling process for an organization seeking recognition of tax-exempt status as a public charity. The new rules no longer require Form 8734 for organizations with advance rulings expiring on or after June 9, 2008. The organization retains its public charity status for its first five years, regardless of the public support actually received during that time. Instead, beginning with the organization’s sixth taxable year, it must establish that it meets the public support test by showing it is publicly supported on Schedule A to Form 990. The Form 1023 has not been updated since this legislation to reflect the elimination of the advance ruling process; however, Part X, Question 6 can be ignored.

Finally, the application should be signed by an officer, director, trustee or other authorized individual at the conclusion of Part X. To the extent that the organization has answered a question that requires additional schedules to be attached, those schedules should be completed and attached. It is not necessary to attach schedules that are not completed. The IRS has included a Form 1023 checklist with the application which serves as a cover page to the application and shows the IRS which schedules are attached.

When attaching any additional pages, the Service requests that those pages each be physically attached to the Form 1023 and have the organization’s name, address and employer identification number in the upper left hand corner of each page along with a statement of the part and line number to which the attachment corresponds.

C. Answering Requests for Additional Information

The Service often requests additional information from the organization seeking exempt status. An organization must timely and completely furnish any additional information requested. Failure to do so can cause the Service to close the file and subject the organization to dismissal of a petition for declaratory relief regarding its exempt status for failure to exhaust its administrative remedies. An

organization is given 20 days to respond to a request for additional information with an extension of 14 days available upon request (some agents do not require a request). Additional time can be requested if necessary for good cause. If the time period expires without additional time being requested and granted, the Service will close the file in a “suspense” mode for 90 days. During this time period, the applicant may submit the requested information and request the file be re-opened. If the 90 day period passes and no response is received, the file will be closed and a new application and new user-fee will be required. [Note: Answering the request for additional information can require as much time and effort as necessary for the initial Form 1023.]

D. Filing Information

The Form 1023 must be filed with the Ohio District of the Internal Revenue Service, P.O. Box 12192, Covington, Kentucky, 41012-0192, within twenty-seven months from the last day of the month in which the organization was established (e.g. the date the certificate of incorporation is issued for a nonprofit corporation). Treas. Regs. § 1.508 (1)(a)(2)(i), (iii). If the organization fails to file Form 1023, or files late, it will not be treated as exempt for any period prior to the filing. Treas. Regs. §1.508-1(a)(1)(i); Rev.Rul. 77-207, 1977-1 C.B.152. The Service may exercise its discretion to extend the time for satisfying the notice requirement of Internal Revenue Code Section 508(a) under Treas. Regs. § 301.9100-1.

For purposes of I.R.C. Section 508(a), the date of notice is the date postmarked on the envelope or, if no postmark appears, the date the application was stamped as having been received by the Service. An extension of the twenty-seven month period may be obtained for good cause.

If an organization submits a substantially complete Form 1023 within the required time period for filing, and files such additional information as the Service may request within the additional time period set by the Service, even though beyond the twenty-seven month filing deadline, the organization will be deemed to have met the filing requirements.

Upon receipt of the Form 1023, the Service will issue a letter acknowledging receipt and advising that it generally takes up to 120 days to review and rule on an organization’s application for exemption. However, this time period is only a general guideline. New organizations that have yet to begin operations may be ruled on more quickly while established organizations with ongoing activities can take longer than 120 days. When an organization has submitted a substantially complete form 1023 and has timely responded to all requests for additional information, the organization may seek a declaratory judgment as to its exempt status following the expiration of 270 days from the date of submission.

E. The Determination Letter

Once the determination letter is received, it should be carefully reviewed, particularly for start-up organizations requesting an advance ruling as additional deadlines will be set forth in the determination letter for such organizations. If the determination letter contains substantive errors, those errors should be brought to the Service’s attention for correction. Finally, after receiving the determination letter, if the organization is a nonprofit corporation, the organization should forward a copy of the determination letter to the Texas Comptroller along with an application for exemption from franchise tax and sales and use tax.

(<http://www.window.state.tx.us/taxinfo/exempt/index.html>).