

JAMISON MANAGEMENT AND DEVELOPMENT
HC 68, Box 79-S, Gila Hot Springs, Silver City, New Mexico
575-536-9339 sznjmsn@gilanet.com

Compiled by Suzanne Jamison for informational purposes only. This does not represent any legal opinions. Updated May 2012.

The first questions to answer are:

- Why should this group/project expend the effort and the money required to become a nonprofit corporation?
- Is the purpose a project or a mission?
- Does this purpose arise from the community to be served?
- Will the organization be broad-based or does it serve a narrow interest group?
- Is the group/project organized for a specific purpose that has a finite lifetime?
- Can the group/project function as an ad hoc project or affiliate with an existing faith-based organization, local government, or other entity with a federal tax exemption?
- If the group decides to incorporate as a nonprofit, is it necessary to obtain federal tax-exempt status?
- If it is decided to file for federal tax-exempt status, what is the plan for organizational sustainability?

Tax Exempt FAQ's

What are the differences between for profit and nonprofit corporations?

For profit corporations are authorized to issue shares of stock to shareholders in return for capital investments. Shareholders receive a return on their investments when dividends are paid or when assets are distributed after dissolution. Nonprofit corporations neither issue shares nor pay dividends, and when a nonprofit dissolves, the remaining assets must be distributed to another similar, tax-exempt, nonprofit group.

No resources of the nonprofit corporation may be used to benefit any board member solely as a function of their board membership. As long as the organization's policies and procedures are followed properly, board members, businesses, and individuals may be paid for contracted goods and services to carry out the nonprofit's programs.

What are the differences between tax-exempt and nonprofit corporations?

Nonprofit does not mean tax-exempt. A "tax-exempt organization" is a unique entity that is usually a nonprofit organization. However, (except in rare cases) a nonprofit organization is not exempt from federal tax until the organization applies for an exemption and the IRS issues a determination of exemption. A group can incorporate as a "nonprofit" under a state or tribal corporation code, but the federal tax-exempt status is a separate step accomplished by filing IRC form 1023.

The state or tribal jurisdiction usually requires annual reports to be filed in order for the organization to remain in good standing. These are commonly available on-line through the jurisdiction's corporation office. Organizations with federal tax-exempt status are required to

file IRC form 990 each year. The first part of this form is sent to Guidestar, which makes it available on-line.

Why form a tax-exempt nonprofit corporation?

Being organized as a nonprofit corporation and obtaining federal tax-exempt status under IRC Section 501c3 may be a requirement for obtaining grant funds from government agencies and private foundations. Generally, tax-exempt government foundations and agencies, as well as private foundations and charities, are required by their own operating rules and by IRS regulations to donate their funds only to 501c tax-exempt organizations. The exception is when funds are donated to 1) tribal government entities which are organized under Section 7871 rules, which state that donations and contributions to tribal governments and tribal government entities are federally tax-exempt, or 2) to other sovereign entities such as cities, school districts, counties, and states and their agencies which meet the IRC “parts” rule.

Federally tax-exempt nonprofit corporations provide donors with the incentive of an individual tax deduction on donations given to a nonprofit with 501c3 status or a tribal entity with 7871 status. Additional benefits include: low cost mailing, discounted advertisements, non-taxable transaction certificates, and other private and governmental discounts. Additionally, many donors check Guidestar for an organization’s federal form 990 as an indication that the organization continues to be current in its reporting, is in good standing with the federal government, and is maintaining its tax-exempt status.

Does our organization qualify as a tax-exempt nonprofit?

To qualify for a 501c3 exemption under the Internal Revenue Code, an organization must carry out mission-related programs in one or more of the areas specifically designated in the Code and be organized for one or more of the following purposes:

- Charitable
- Religious
- Educational
- Scientific
- Literary
- To alleviate poverty and promote the public good
- Testing for public safety
- Fostering national or international amateur sports competition
- Prevention of cruelty to children or animals

Additional tax exemptions exist under separate sections of the IRC for groups including: labor unions, chambers of commerce, social and recreational clubs, fraternal societies, civic leagues, credit unions, farmers’ co-ops, mutual insurance companies, and legal service organizations.

What are the disadvantages of forming a tax-exempt nonprofit?

Your nonprofit income activities, “related business income,” will be in most part restricted to the stated tax-exempt purpose of your organization. Income from sources unrelated to the purpose

of the organization will be taxable as “unrelated business income.” If this unrelated income starts to become a substantial portion of the income earned, this could attract attention from the IRS and prompt a reconsideration of the federal 501c3 tax-exempt status.

Additionally, individuals cannot benefit from the value of any assets of the nonprofit corporation. There is no “equity” to be developed by the board members or workers. All assets of the corporation must be dedicated to its tax-exempt purposes. Upon dissolution of the corporation, all assets must be distributed to other 501c3 corporations. Furthermore, payments of dividends to shareholders or payments of profits to directors, officers, members or staff are prohibited; however, reasonable salaries and contract services are allowed.

Can a nonprofit corporation make a profit?

Yes. To be fiscally responsible and healthy, a nonprofit corporation must take in more money than it spends. It can use the tax free profits for its mission-based programs and operating expenses, including salaries. What a nonprofit corporation can not do is distribute any profits to officers, directors, or employees. Individuals serve on the Board of Directors as volunteers. Members of the Board of Directors are not paid for being on the board nor for attending meetings, although they may be compensated reasonably for expenses incurred to attend the board meeting, according to IRC regulations about eligible volunteer expenses. Today, some boards of large nonprofit corporations, especially boards of nonprofit health care institutions, are paid to serve as directors, primarily due to liability issues. Additionally, compensation can include providing child care and a meal or refreshments for the meeting.

What is needed to establish the tax number?

Once the organization is formed, even if the Articles of Incorporation have not been completed, fill out federal form SS-4, Application for an Employer Identification Number. Calling the Department of Treasury directly, 800.829.4933, is the fastest way to obtain this EIN. The EIN is the number that the organization will need to establish its legal status. An EIN is like a social security number for individuals. It is used to track organization activity, is required to open a bank account, and is needed on many other types of forms.

Once the EIN has been obtained, call 866.705.5711 to obtain the Data Universal Numbering System number, which is managed by Dun and Bradstreet Corporation. If you only have a PO Box as your mailing address and no street numbers, then you will use the physical address of your local post office as the geographical address required by DUNS.

Is the corporation required to file both federal and state exemption requests?

The nonprofit incorporation is executed in the state or tribal jurisdiction. This is where the articles and by-laws are filed. The state or tribe will issue a certificate of nonprofit incorporation if the articles and by-laws are approved. To facilitate this process and protect the integrity of the organization, be sure to include in the initial articles and by-laws all language that the IRS requires for 501c organizations.

When writing the organization's mission and activities components, be sure that they conform to the type of 501c organization for which the incorporators may subsequently seek federal exemption. Do not cut corners on developing and writing these very important founding documents.

Once the state or tribal incorporation is accepted, then the organization may chose to file form 1023 to apply for federal tax-exempt status under IRC Section 501c, which includes a range of tax-exemptions. The incorporated nonprofit submits form 1023 to the federal government requesting tax-exempt status. It is better to do this correctly the first time, so seek the advice of a professional with this particular expertise. The form must be accompanied by a filing fee, which is based on the anticipated gross receipts in the first four years of operation.

The 501c3 designation is the most common status for the purposes of operating with the greatest latitude, accepting private donations, and receiving grants from private foundations and government entities.

Although most state tax-exempt laws are patterned after the Internal Revenue Code, obtaining state sales tax exemption is a separate process from obtaining federal income tax exemption. Even if an organization has obtained federal exemption, it must follow the procedures of the state corporation or franchise tax board to obtain state tax exemption. In some states, it is possible to obtain state tax exemption before securing federal exempt status. This exempts the organization from paying the state sales tax for purchases of goods; services are taxed at the regular rate.

Currently, the Navajo Nation has no provisions for exemption from tribal sales tax for nonprofits incorporated through the tribe. The Hopi Tribe does not charge any taxes. The States of AZ, NM, and UT do not offer nontaxable transaction certificates for tribally-incorporated nonprofits, although there is legislation that exempts Tribal organizations from paying some taxes on items purchased outside of the Tribal jurisdiction. Some companies will not charge tax if the mailing address of the purchaser is in another state from where the seller is located.

Benefits of 501c3 Tax Exempt Status

The recognition of your organization as a 501(c)(3) tax exempt entity by the Internal Revenue Service (IRS) includes benefits such as:

- Tax free income - Income earned by the organization is deemed tax-free, if earned from activities that relate to the organization's mission and purpose.
- Tax exempt purchases - Can apply for non-tax transaction certificates to eliminate paying tax on most goods purchased for organization's programs and purposes. Services are still taxable.
- Tax deductible donations - Individual and corporate donors can make charitable contributions of cash, goods, services, or other assets for which they may receive a tax deduction on their tax return, depending on the donor's tax situation.
- Employee benefits - Employees may be eligible for various fringe benefits such as group life insurance, health insurance, health care savings accounts, pension plans, etc.
- Grants – The organization may qualify to receive private and public grant money.

- Postage - Eligibility to obtain a bulk rate permit in order to reduce postage rates on corporate mailings of 200 or more pieces.
- Public Service Announcements – Can submit information to media outlets to request free announcements and promotion.
- Limited liability and board insurance – Limited liability and insurance for the directors and officers of the organization.

Disadvantages of 501c3 Tax Exempt Status include:

- Restrictions on activities and types of income.
- Attracting enough qualified and dedicated volunteers to serve on the board.
- Reporting annually on the IRC form 990.
- Reporting annually or as required to the State or Tribe of where the corporation is recognized as a nonprofit.
- Challenges with obtaining loans or raising capital for funding activities.
- Public misperceptions, lack of knowledge, and/or prejudices about nonprofits and tax-exempt organizations.