

5 steps to forming a nonprofit corporation

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A [501\(c\)\(3\)](#) nonprofit corporation is a type of charitable organization that the [Internal Revenue Service](#) recognizes as tax-exempt. This type of corporation does not pay income tax on its earnings or on the donations it receives.

Also, any time taxpayers make a donation to a 501(c)(3) nonprofit, they can reduce their taxable income by the amount of their donation if they [itemize their deductions](#) on their [federal income tax](#) return. This incentive encourages private charity and makes it easier for nonprofits to raise money. (For related reading, see "[Navigating Government And Nonprofit Financial Statements.](#)")

TUTORIAL: [Personal Income Tax Guide](#)

If you've ever wanted to raise money for a cause on your own terms, you might want to start a 501(c)(3). This article describes what you should consider before you decide and tells you how to get started if you decide to move forward.

Why Form A 501(c)(3)?

The best reason to form a 501(c)(3) nonprofit corporation is because you've determined that it is the most effective way for you to pursue a charitable goal. Maybe there is a need that isn't being fulfilled by existing organizations; maybe you think you have a better idea that will meet a need more effectively than what any existing organization is doing. But first, do think about whether you will best be able to accomplish your aims by forming and running a new organization or whether you could do more good by donating your time and/or money to an existing organization.

You don't have to become an IRS-recognized nonprofit organization to start a charity. However, people will be significantly more interested in donating if their gifts will be [tax deductible](#). Also, obtaining 501(c)(3) status means that potential donors are more likely to see your organization as legitimate. Much of the financial and operating information that 501(c)(3)s are required to report to the IRS becomes public record, so these organizations can easily be scrutinized and held accountable if donors think their funds are being misused. (For more, see "[Deducting Your Donations.](#)")

If you decide to operate as a 501(c)(3) and the IRS gives you the green light, your organization won't pay income tax on the money it earns from its fundraising activities and the donations it receives. Also, incorporating your organization helps protect your personal [assets](#), though you could incorporate without becoming a 501(c)(3).

Next, let's review the five steps that will make your nonprofit a tax-exempt business.

1. Plan

The IRS says that if you want to operate as a 501(c)(3), your organization must exclusively pursue an activity in one of the following categories:

- religious
- charitable
- scientific
- literary or educational
- testing for public safety
- fostering national or international amateur sports competition
- preventing cruelty to children or animals

You should also be sure that your organization is not designed to [profit](#) an individual and that it provides a [public benefit](#).

2. Form a Corporation

Once you've determined that you want to proceed and that your organization roughly meets the IRS requirements, it's time to start dealing with the red tape. Decide if you want help; you can hire a lawyer if you have the resources, or use a do-it-yourself legal service like LegalZoom.com if you don't. A lawyer can provide personalized guidance and help you avoid costly mistakes, but some people do manage on their own.

Corporations are formed at the state level, so you'll need to find out what the procedure is to form a [corporation](#) in the state where your organization will be based. The steps vary by state but will generally include the following:

- Name the corporation, making sure that your name is unique and permissible. In other words, you can't use a name that someone else has already claimed. Also, there are certain words the government doesn't allow corporations to use in their names in an effort to prevent businesses from misleading the public.
- Prepare and file articles of [incorporation](#). The articles of incorporation are the document that creates your corporation.
- Appoint one to three [directors](#), depending on your needs and state requirements. All corporations must have directors whose responsibility it is to oversee the organization, advise management and make key decisions such as hiring and firing the company's executive officers.
- Hold a directors meeting in which you appoint/elect officers and prepare organizing document and bylaws. Also, start a record book where you keep minutes from this and subsequent meetings.
- Get a state [tax identification number](#). A corporation is considered an independent taxpaying entity and must have its own tax number (similar to an individual's [Social Security number](#)), even if it is a not going to pay taxes.

In addition to following the official, required steps, it's not a bad idea to make a [business plan](#), just like you would if you were starting a for-profit business. Although your organization will be a nonprofit, you will still have to operate in the black if you want to keep it running. Nonprofits are allowed to make money; they just have to use those profits to further the organization's public purpose. By contrast, a private corporation exists to enrich its employees, managers and shareholders. (For related reading, see "[Gifting Your Retirement Assets to Charity](#).")

3. File Paperwork with the IRS

After meeting your state's requirements for forming a corporation, you're ready to apply for tax-exempt status with the IRS.

First, you'll need to apply for an [employer identification number \(EIN\)](#). This is a requirement for all tax-exempt organizations, even if they don't have employees. You can apply online through the IRS website, by phone at 1-800-829-4933, or by mailing in Form SS-4, Application for Employer Identification Number.

Next, complete and submit Form 1023, Application for Recognition of Exemption Under Section 501(c)(3) of the [Internal Revenue Code](#). The information that you include on this form will serve as the basis of the IRS's decision of whether to grant your organization tax-exempt status. Set aside plenty of time for this task: the main application is 12 pages long and quite detailed.

Also, depending on the type of organization you are forming, you will also need to fill out one of the attached schedules (e.g., Schedule A for churches; Schedule B for schools, colleges and universities; etc.) The IRS estimates the time to complete Form 1023 at about 90 hours for recordkeeping requirements, 5 hours to learn about the form, almost 10 hours to prepare the form and another hour to copy, assemble and mail the form. That's not including the schedules.

Before mailing your application, follow the directions on the Form 1023 Checklist. The list helps ensure that you've included all required information in your application and will help to prevent delays in processing.

Submit your application. The IRS will let you know if it needs more information or if your form has been forwarded for review. Once the IRS has all of the information it requires, it will issue a [determination letter](#) either granting or denying tax-exempt status to your organization. The evaluation process usually takes three to five months. If you are denied, you can appeal. (For related reading on the IRS, see [How To Appeal Your IRS Audit](#).)

4. Comply With State and Local Requirements

If your organization gets approved for tax-exempt status at the federal level, that's great. Next, you'll need to make sure your organization will also be tax-exempt at the state and local levels so it doesn't have to pay [state corporate income tax](#), [sales tax](#) or [property tax](#).

Requirements vary by state, but your IRS approval may be all your organization needs to also be recognized as a [nonprofit](#) at the state level.

Once you've met your state's requirements for operating as a nonprofit, you'll need to get any [permits](#) or licenses required to operate your business and make sure to comply with building codes and other local regulations. Being a nonprofit only exempts you from taxes; it does not exempt you from meeting the other requirements for your business type in the area where you will operate.

Also, before you start operating, get familiar with corporate requirements, such as holding meetings, keeping minutes and filing information returns.

5. Maintain Your Status

Once you've been approved at every level, there's still work to do. Maintaining your nonprofit status is an ongoing process, and the consequences are severe if you don't follow the rules. Here are 11 things you need to do on an ongoing basis.

1. Make sure your organization operates in the way you said it would in your application.
2. Hold regular meetings of the [board of directors](#) and take notes.
3. Comply with annual IRS requirements to file Form 990 or Form 990-EZ. In these forms, you will report your organization's activities, governance, [revenue](#), [expenses](#) and net assets. Be aware that your completed form will be publicly available. Also, your state government may require a copy.
4. Have diverse funding sources. 501(c)(3) organizations are supposed to be public; if you have too few funding sources, you might have to reorganize as a [private foundation](#). Foundations must operate by a completely different set of rules.
5. Run your organization like a business with its own bank account and [credit card](#). Keep all financial transactions completely separate from your personal accounts.
6. Keep impeccable financial records in case your organization is [audited](#).
7. Do not allow your organization to participate in any political campaigns.
8. Do not unjustly enrich anyone compensated by your organization.
9. Do not use your organization to further non-exempt purposes or to commit illegal acts.
10. Do not allow a substantial part of your organization's activities to be geared toward influencing legislation.

11. Avoid earning unrelated [business income](#) through your organization. This is income from an activity that is regularly carried on and is not substantially related to your organization's purpose. Such income is subject to the [unrelated business income tax](#).

12. If you have a sizeable number of employees, consider starting a [qualified retirement plan](#). These plans resemble [401\(k\) plans](#) in many respects, but are specially designed for nonprofit entities. For more, see "[The 4-1-1 on 403\(b\) Plans](#)."

The Bottom Line

Starting a 501(c)(3) can be an exhausting process. Before you tackle the challenge, weigh the pros and cons of meeting all the legal and tax requirements of forming and operating an official nonprofit organization. But it may well be worth it: People may donate more than they otherwise would because of the tax [exemption](#) and perceived increase in legitimacy 501(c)(3) status conveys.

(For related reading, see "[Do Nonprofit Organizations Pay Taxes?](#)")