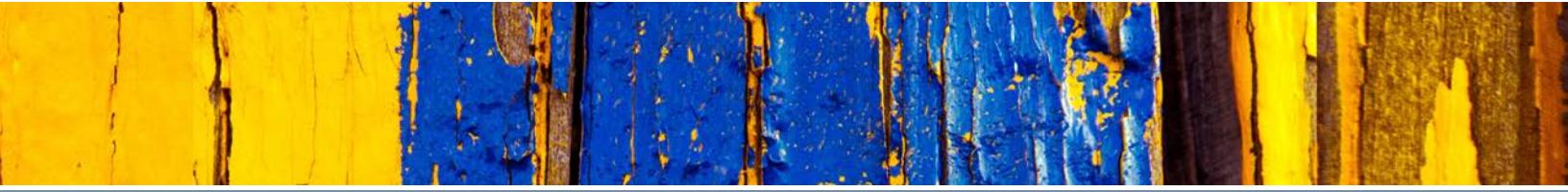


7 Important Considerations Before Forming a Section 501(c)(3) Organization

Parties interested in forming a Section 501(c)(3) nonprofit entity face a number of compliance burdens

January 30, 2020



Although Section 501(c)(3)¹ status can be the right fit for many organizations, it also comes with a number of burdens that should be evaluated prior to forming a nonprofit entity and applying for federal income tax exemption. This guide highlights seven key challenges that come with Section 501(c)(3) status.

1. Forming a new entity, applying for exemption, and fundraising can be expensive

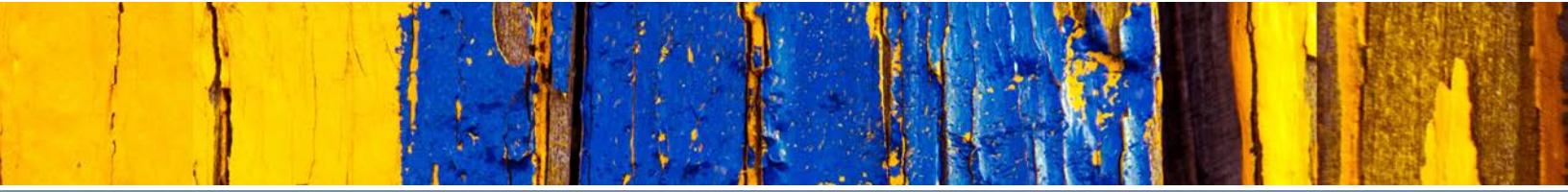
In most cases, forming a Section 501(c)(3) organization involves incorporating a nonprofit entity in a state, registering to do business where necessary, and submitting applications for federal and state income tax exemption to the relevant tax authorities. The process involves incurring a number of fees, including those related to filing articles of incorporation, registering to do business, maintaining a registered agent, filing annual or biannual reports,² and applying for federal and state income tax exemption. Most states require charities to register to solicit charitable contributions (*i.e.*, engage in fundraising), and a simple “Donate Now” button on a website could trigger a registration requirement in several states. Overall, these “maintenance” obligations are time-consuming and expensive, and often necessitate hiring outside advisors. For example, most organizations need to hire an accounting firm to assist with federal and state tax return preparation and filing. Accounting firms do not typically offer accounting and audit services on a pro bono basis.

2. Section 501(c)(3) organizations face a complex regulatory regime that often requires obtaining advice from lawyers and accountants

The IRS, state tax authorities, and state attorneys general all regulate Section 501(c)(3) organizations. The laws applicable to these organizations are complex and cover a broad range of matters such as board governance, lobbying, campaign activities and nonpartisan voter education, the public support test necessary to establish “public charity” classification, the unrelated business income tax, and the substantiation of charitable contributions. Section 501(c)(3) organizations classified as private foundations (rather than as public charities) are subject to an even more comprehensive excise tax regime. Navigating these laws often requires the ongoing engagement and advice of lawyers and accountants.

3. All assets of a Section 501(c)(3) organization must be dedicated to a tax-exempt purpose, including upon an organization’s dissolution

Founders of Section 501(c)(3) organizations often contribute funds, intellectual property, and other assets to the organization, but they are not entitled to the return of these assets upon a dissolution. Instead, these assets must be retained by the organization or distributed for Section 501(c)(3) purposes, typically in the form of a donation to another Section 501(c)(3) organization, in the event of dissolution.



4. Section 501(c)(3) organizations cannot pay dividends or make unreasonable payments to any private parties, including founders and other insiders

Although Section 501(c)(3) organizations can earn revenues that exceed expenses — including revenues from trades or businesses substantially related to their exempt purpose — they cannot use the profits from such activities to award dividends or make unreasonable financial payments to private parties. Instead, all compensation paid, including to the founder, must be reasonable and determined at arm's length. A determination of reasonableness should be based on an evaluation of the amount that would ordinarily be paid for like services by like organizations in like circumstances. Failure to comply with the applicable rules can subject the organization's managers and certain recipients of excess payments to substantial financial penalties.

5. A board of directors, as opposed to a founder, often must oversee the activities of a Section 501(c)(3) organization

State nonprofit corporation laws generally require that a board of directors oversees the activities of Section 501(c)(3) organizations. In general, as a best practice, the board should consist of at least three directors, a majority of whom are independent. Although a founder can serve on the board and/or serve as an executive director in order to carry out the organization's day-to-day activities, he or she is ultimately accountable to the other individuals serving on the board.

6. Section 501(c)(3) organizations face significant public scrutiny, and their activities, including compensation practices, are subject to public disclosure

Section 501(c)(3) organizations must make their applications for federal income tax exemption and their annual information returns available to the public. These applications and returns may include information about the organization's finances, related entities, grant-making, and compensation paid to directors, officers, key employees, and certain highly compensated employees and independent contractors. Some states also post charitable solicitation registration filings online. As a result, an organization's practices and activities are subject to significant public scrutiny.

7. A Section 501(c)(3) organization's tax-exempt status will be revoked if the organization fails to file the required annual information return with the IRS for three consecutive years

Most Section 501(c)(3) organizations must file a Form 990, Form 990-EZ, Form 990-N, or Form 990-PF annual information return with the IRS each year. If an organization fails to do so for three consecutive years, the IRS will revoke its tax-exempt status. An organization that loses its tax-exempt status can apply for retroactive reinstatement, but it will need to demonstrate that there was reasonable cause for the failure to comply. In addition to this filing requirement, organizations that engage in business activities unrelated to the organization's exempt purpose may be required to pay federal and in some cases state income tax on any resulting net income, and to file separate returns for the payment of such taxes.

Conclusion

Section 501(c)(3) organizations are subject to a variety of complex federal, state, and local rules and requirements. Operating even a modest organization in compliance with these rules requires diligent effort and an ongoing commitment of time, attention, and resources. Section 501(c)(3) organizations cannot run themselves or be set up and then left on autopilot. Failure to devote the necessary time and effort to the operation of a Section 501(c)(3) organization invariably leads to problems, many of which can be costly to resolve. Parties seeking to form a new Section 501(c)(3) organization should carefully consider and affirm their ability to carry out these obligations before moving forward.

Contact

Kimberly Eney

kimberly.enary@lw.com
+1.202.637.3376
Washington, D.C.

The information contained in this publication should not be construed as legal advice. Should further analysis or explanation of the subject matter be required, please contact the lawyer with whom you normally consult. The invitation to contact is not a solicitation for legal work under the laws of any jurisdiction in which Latham lawyers are not authorized to practice.

Endnotes

¹ All Section references are to the Internal Revenue Code of 1986, as amended.

² Failure to file the report can result in a revocation of the corporation's charter or registration to do business.