

# Forming a non-profit corporation, becoming tax exempt

By Leo Cashman, Minneapolis, Minnesota

## Why Incorporate?

Activist groups sometimes ask: is it really necessary to incorporate our health freedom groups? Can't we avoid the usual incorporation costs? One way to answer that is to consider alternative forms that are so familiar in the world of small business: the sole proprietorship and the partnership. They are non-corporation forms of running an organization, so clearly they seem to be quicker and perhaps easier to set up.

Consider a hypothetical health freedom group wanting to get started and set up a bank account. The group chooses one or more people to sign checks and otherwise manage the affairs of the business; let them run the organization as a partnership (two or more owners) or a sole proprietorship (one owner) under their names. The bank may be quite willing to set up such a business checking account, as long as the one or more owners provide proper identification. At first glance it may look like smooth sailing – the name of the health freedom group is printed on the checks. Is there a problem looming here?

Yes. Let us list some of them:

- The owners are personally liable for the debts and obligations of the organization. – The partners will be personally taxed on any excess of Revenue over Expense that occurs in a given year.
- Because of the for-profit purpose inherent in partnerships and sole proprietorships, they cannot become tax exempt. Contributions will not be tax deductible for the donor.
- The owners will not be bound by the decisions of a larger group of members.
- And what if there is a coming or going of some of the listed partners? The entire partnership dissolves!

Clearly, from the above, we can see that the common unincorporated forms – sole proprietorship and partnership – are not appropriate or even feasible for a group that is inherently not a business but, rather, has an educational, not-for-profit purpose. In order to form something that endures as an ongoing entity, the group should form a Non-profit Corporation.

## Idea of a Corporation

What, exactly, is a corporation? A corporation is an artificial person, formed under the provisions of the laws of a state, that exists independently of the coming and going of particular individuals. The structure of a corporation anticipates that there will be a coming and going of individuals –

there will be changes of stockholders (in a business type of corporation) or of members and directors (in the non-profit setting) and the structure of the corporation facilitates such coming and going of individuals while the corporation and its governance continues on.

Groups with a non-profit purpose, such as education or legislative reform, must decide which state they want to incorporate under. Every state has its own state statute that provides for the formation of non-profit corporations. The non-profit statute is appropriate for groups which have a charitable, educational, scientific or religious purpose, but also can be used for groups which want to lobby and bring about legislative change, or for trade associations. In addition to specifying the name of the corporation and other basic features of it, the Article of Incorporation must specify the general purpose of the corporation (e.g. "charitable and educational) and also the specific purpose (e.g. to educate the public on the issue of health freedom and consumer access to the kind of health care they desire).

The Articles of Incorporation are supplemented by the ByLaws, which fill in more details of the structure of the organization. The Articles and ByLaws should be drawn up not only to comply with the requirements of the state in which you are incorporating, but also should contain language that will enable your group to become tax exempt with the Internal Revenue Service (IRS). Becoming tax exempt with the IRS is a separate step, one that follows the act of incorporation, and the IRS will look for needed language in the Articles of Incorporation that the state may have ignored.

The Secretary of State is usually the state agency that receives and approves Articles of Incorporation. The Articles of Incorporation name the new corporation, specify the general purpose of it, and also specify a more specific purpose. It typically names the first Board of Directors – the group that, under law, governs the business and affairs of the corporation.

Every board meeting should have meeting minutes that record the decisions made and the board meeting minutes form a chain of authority and decision making that extends from the moment of creation – the incorporation with the filing of the Articles – through out the whole history of the corporation. In case there are hassles or disputes, down the line, that chain of authority and decision-making becomes important in determining who has actual decision making power and what has been decided.

## **Tax exemption**

In the US, tax exemption is obtained by applying for a specific type of exemption under the provisions of section 501© of the Internal Revenue Code.

In reviewing your application for tax exempt status, gives your Articles of Incorporation and ByLaws special scrutiny to see if they have the language needed to allow the type of tax exemption that is needed. IRS will also scrutinize a questionnaire type of form that you fill out.

If the non-profit is primarily educational, it should seek a tax exemption under the provisions of IRC 501©(3); under such a tax exemption, contributions by a donor may be tax deductible for the donor – a great encouragement for the larger donors. However, the non-profit with a 501©(3) tax exemption can only do an "insubstantial" amount of lobbying. Usually a separate non-profit group is formed with an eye to being able to do unlimited lobbying and to do so under a different type of tax exemption – a 501©(4) tax exemption.

Fill out IRS booklet – Form 1023 in order to apply for the 501(c)(3) tax exemption. Fill out booklet – Form 1024 to become 501(c)(4) tax exempt.

Once 501(c)(3) status is achieved, your group may be able to go further and become Sales Tax Exempt from the sales tax in your state. That is not automatic and is an entirely separate step! Inquire with your state about applying for Sales Tax Exemption. You may also check with the US Postal Service about their requirements for doing bulk mailings at reduced prices for a tax exempt non-profit. The savings on postage are substantial!

See the Alliance for Justice <http://www.afj.org>, (phone 202-822-6070) for booklets on non-profit lobbying and on the issue of non-profit tax exemptions.