

A STEP-BY-STEP GUIDE TO FORMING AN EXEMPT ORGANIZATION

Currently, there are over 1.5 million exempt organizations in the United States, with the Internal Revenue Service (IRS) granting exempt status to approximately 50,000 new organizations annually. This article focuses on the steps to create an exempt organization, particularly a §501(c)(3) public charity, which constitutes the great majority of all exempt organizations in the United States.

Similar to the formation of any corporation, there are required steps an organization must undertake before commencing charitable operations. First, a corporate entity must be formed, generally within the state where the exempt organization plans to operate. There are generally no advantages to incorporating in a state such as Nevada or Delaware if the exempt organization plans to be based in California. Next, and most importantly, the organization must obtain tax-exempt status from the IRS.

For an organization seeking to be recognized as a non-charitable exempt organization, Form 1024 should be filed with the IRS. For public charities and private foundations, the process to obtaining tax-exempt status is more burdensome; the Form 1023 is required to be filed with the IRS in order to receive recognition as a §501(c)(3) entity.

STEP 1: FORMATION OF CORPORATION

An organization must first file its Articles of Incorporation in the state in which it is planning to operate. In many states, including California, the Articles of Incorporation for an exempt organization or public benefit corporation require certain clauses, wording, and provisions. In California, it currently takes approximately six to eight weeks to receive a certified copy of the Articles of Incorporation. This time frame can be reduced to two weeks if the Articles of Incorporation are personally delivered to an office of the California Secretary of State.

STEP 2: APPLYING FOR FEDERAL EMPLOYER IDENTIFICATION NUMBER

An Employer Identification Number (EIN) for the exempt organization can be obtained relatively quickly from the IRS' web site (www.irs.gov). However, in order to do this, the exempt organization's Articles of Incorporation must have been accepted by the state of incorporation.

STEP 3: COMPLETION OF THE FORM 1023 (FEDERAL TAX EXEMPTION APPLICATION)

This is the most essential and time-consuming step in the entire process. The Form 1023 includes a 12-page core form with eight different schedules to be completed, if applicable. To file a complete and accurate Form 1023, the organization should have an initial Board of Directors in place, by-laws implemented, and a conflict-of-interest policy in effect. The Form 1023 also requests many details regarding the planned operations of the charitable organization, including a projected budget, detail on fundraising activities, and documentation regarding the entity's planned governance practices. The Form 1023 is filed with a fee of \$850. If the exempt organization meets the standards of being a "small" exempt organization (projected revenues of less than \$10,000 a year), the filing fee is decreased to \$400. Some of these small exempt organizations may be eligible to file the Form 1023-EZ. This simplified form is only three pages long and can be completed online at Pay.gov.

Form **1023**
Rev. December 2013
Department of the Treasury
Internal Revenue Service

Application for Recognition of Exempt Status Under Section 501(c)(3)
(Use with the June 2006 revision of the Instructions)

Use the instructions to complete this application and for a determination of eligibility. For more information, call the IRS Business Operations Customer Account Services toll-free at 1-877-829-5500. If the required information and documents are not sufficient, additional sheets to this application may be returned to you. Each answer sheet by Part and line number. Complete Parts I - X and apply to you.

Identification of Applicant
Name of organization (exactly as it appears in your records)

After filing the Form 1023, it could take the IRS anywhere from two months (for a green-lighted application) to more than one year (for a yellow-lighted application) to determine whether to approve the Tax Exemption Application. There are options for expediting the process, but certain requirements need to be met in order to take advantage of this. Once the organization receives a Determination Letter from the IRS, it is considered to be a tax-exempt entity for federal tax purposes retroactively back to the date that the entity was formed (assuming that date was less than 27 months before the date noted on the organization's Determination Letter).

STEP 4: FILING FOR STATE TAX-EXEMPT STATUS

Although each state has its own set of exemption rules, generally, once the organization receives its Determination Letter from the IRS, the state determination process should be relatively straight-forward. For example, within California, a charitable entity needs to file a Form 3500A with the California Franchise Tax Board to seek tax exemption status.

STEP 5: FILING WITH THE STATE ATTORNEY GENERAL

The final step in the process will generally be a filing with the Attorney General in the exempt organization's particular state of operation. For example, in California, the Attorney General requires that most charitable organizations (churches, schools, hospitals are excluded) register with the Registry of Charitable Trusts by filing Form CT-1. A \$25 fee is required to be included with this filing.

STEPS OF EXEMPT ORGANIZATION APPLICATION PROCESS			
STEP	DESCRIPTION	WHEN TO START	TIMING
1	Formation of Corporation	Immediately	6 - 8 Weeks
2	Apply for Federal EIN	After Receipt of Certified Articles of Incorporation	Online: Immediate Paper: 2-3 weeks
3	File Form 1023 with the IRS & Respond to Any IRS Follow Up Questions	After Receipt of EIN	3 - 18 months
4	File for State Exempt Status	After Receipt of Federal Determination Letter	1 - 2 months
5	Register with State Attorney General	After Receipt of Federal Determination Letter	1 - 2 months
Total Estimated Time Frame for Formation of Corporation			6 - 24 months

Completion of the above five steps, while seemingly straightforward, are almost never as simple in practice. In 2015, 101,962 organizations applied for exempt status, with the IRS rejecting 67 (less than 0.07%) of those applications. While this rejection rate is not severe, it excludes the 6,590 applications that were withdrawn or returned as "incomplete." The process from start to finish can be much more efficient and effective if each step is accurately completed in the most appropriate way. We have seen firsthand the importance of filing a complete Tax Exemption Application and responding quickly to follow-up inquiries from the IRS.

The Windes Nonprofit Group can assist organizations in the formation process. We can prepare the Form 1023 or undertake a top-level review of the Form 1023 if the organization has created a draft of it themselves.

For more information about forming an exempt organization, please contact Donita Joseph at djoseph@windes.com or by phone at (562) 435-1191.