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# General Questions for Starting Nonprofit Organizations

Prepared

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## GENERAL QUESTIONS FOR STARTING NONPROFIT ORGANIZATIONS

These questions and answers were prepared by Associate Attorney Ryan Oberly as a public service project for the Illinois Attorney General's Office. The comments apply to organizations that may be tax-exempt under Internal Revenue Code section 501(c)(3), explained in further detail below. It is important to note churches and similar religious organizations may not be affected by some of the questions and answers included below.

### I. Preliminary Considerations

#### A. *What do I need to do to get started?*

First, you should determine the purpose and mission of your organization. To be considered for tax exemption under Federal law as discussed below, the purpose must be religious, educational, charitable, scientific, literary, testing for public safety, fostering national or international amateur sports competitions, or preventing cruelty to children or animals.

Give careful consideration to how the organization will be funded, who will operate it and whether or not there is a real need for such organizations. Many new organizations start to address a perceived need that is not in fact a need felt within the community to be served. It might be appropriate to survey a portion of people within the area to determine which needs are most important.

Once an organization has its purpose and mission and has determined that starting a new organization is the best option, it should assemble a board of directors that can help implement the organization's purpose and mission.

#### B. *What is considered a nonprofit?*

The term "nonprofit" refers to whether an organization's profit can be passed along or transferred to the private individuals who control the organization. While a nonprofit organization can make a profit, the profit it earns must be used toward the organization's activities.

### II. Forming a Nonprofit Organization

#### A. *How do I form my organization?*

Creating a legal entity under state law is the first step in forming a nonprofit organization. While a charity can be formed using different legal entities, the most common is a nonprofit corporation. A nonprofit corporation commences into existence by filing articles of incorporation with the Illinois Secretary of State's Office.

*B. What are articles of incorporation?*

The articles of incorporation is a brief legal document that represents the basic charter of a corporation. The document lists the organization's name, basic purpose, and other important pieces of information about the corporation. In effect, articles of incorporation are like a license that authorizes a group of people to conduct certain activities.

*C. What needs to be included in my articles of incorporation?*

In addition to an organization's name and basic purpose, the articles of incorporation must include the names and addresses of the directors, registered agent, and the incorporators.

If the nonprofit organization wants to become tax-exempt under sec. 501(c)(3) of the Internal Revenue Code ("IRC") as discussed below, the organization should also carefully define its purpose to fall within the categories listed in Question One above.

The articles of incorporation should also include a statement that the organization will use its income and assets toward its charitable purposes. Finally, articles of incorporation should state how the organization's assets will be distributed in the event the corporation is dissolved.

*D. What is a registered agent?*

A registered agent serves as a corporation's official communication point. Accordingly, the agent receives service of process for lawsuits, acts as the main mailing contact with the Illinois Secretary of State and other regulatory agencies, and forwards any court notices and state reports to the organization. At all times, the registered agent must be a resident of the state or a company that has been licensed by the state to serve as a registered agent.

*E. Can I start my organization before it is incorporated?*

Illinois law requires that all corporations conducting activities in Illinois must be registered with the Secretary of State. Any activities prior to incorporation may be considered unlawful and beyond the authority of Illinois law. Furthermore, persons acting and representing themselves in the name of a corporation that does not exist may be subject to possible criminal sanctions.

*F. Should I hire an attorney?*

While an individual may be able to fill out the paperwork necessary to incorporate a nonprofit organization, the information the organization provides will have major ramifications as the organization operates. Nonprofit law is complex and errors in the initial stages of incorporation may be costly to correct. Hiring an attorney with a significant knowledge of nonprofit law will enable the organization to start with a solid foundation.

G. *What are bylaws?*

Bylaws are a set of resolutions the board of directors will approve to govern how the organization will be structured and operate. Bylaws are like a set of rules that control a game. The complexity of a nonprofit organization is limited only by the imagination of its founders and the practicality and skill of those who draft its bylaws. The express language of the bylaws should describe the most important aspects of order and structure in the organization.

Bylaws will typically include the following: a statement of corporate authority; the statement of purpose outlined in the organization's articles of incorporation; limitations on the corporation's activities or authority; whether the organization will have members and the requirements for such members; voting rights for the corporation's directors and/or members; notice requirements for meetings; and additional information regarding the roles of officers and committees within the organization.

### **III. Registrations and Applicable Government Regulations**

A. *What must my organization do to be exempt from federal income tax?*

Organizations seeking federal tax exempt status must meet specific statutory criteria set forth in the applicable provisions of the Internal Revenue Code. Unless the organization is a church or normally receives \$5,000.00 or less in annual gross revenue, the first step is to file an application for recognition of tax exempt status with the Internal Revenue Service ("IRS"). In the case of charitable organizations, the IRS Form 1023, Application for Recognition of Exemption, is used. This application includes a description of the past, present, and future activities of the organization, its fund-raising and financial information, and the composition of its board of directors. The organization must also include its articles of incorporation and bylaws with the application. Great care should be taken in completing the 1023 application, as it will be a historical document reflecting the organization's identity and well-done applications typically result in better IRS processing. The filing fee for 1023 applications is generally \$750.00 (there are some minor exceptions). The application typically takes between four to six months to be processed by the IRS. If the application meets the approval of the IRS, an organization is notified of whether it will be recognized as tax-exempt by receiving a "determination letter."

B. *What must my organization do to be exempt from state income taxes?*

An Illinois organization that has been recognized by the IRS to be tax exempt under IRC sec. 501(c)(3) will be automatically exempt from Illinois income taxes.

C. *What must my organization do to be exempt from state sales taxes?*

Sales tax exemption enables qualified organizations to purchase merchandise tax-

free, and may serve as a precursor to receiving property tax exemption. While sales tax exemption allows an organization to purchase items tax-free, it must generally pay taxes on items it sells in the ordinary course of business.

To qualify for sales tax exemption from state and local sales taxes, an organization must be a qualified organization generally organized and operated for charitable, religious, education, or governmental purposes and recognized to be tax exempt under IRC sec. 501(c)(3). If these requirements are met, an organization should send a letter requesting exemption to the Illinois Department of Revenue. For further information, visit [www.revenue.state.il.us](http://www.revenue.state.il.us).

*D. Does my organization need to register with the City of Chicago?*

While the City of Chicago does not have a mandatory registration for all charitable organizations, it does require organizations to obtain permits for certain business-type activities. For example, charitable organizations will need to obtain a permit from the City of Chicago in order to conduct a raffle. In addition, an organization may also be required to obtain a business license for certain activities (such as selling food for consumption). For further information on various permits and registrations the City of Chicago requires, see the “Licenses, Permits, and Taxes” section at <http://egov.cityofchicago.org>.

*E. Do I have to register with the Attorney General’s Office?*

Under Illinois law, all organizations that solicit or plan to solicit from persons in Illinois must annually file with the Attorney General’s Office a registration statement and fee of \$15.00 within six months of the end of its fiscal year. In addition, all organizations that hold property for charitable purposes in excess of \$4,000.00 must file the same registration statement. The organization must include an annual financial statement the requirements for which vary depending on the amount of contributions the organization receives in the preceding year.

There are no limits on how much money an organization may solicit. However, if an organization’s gross revenues for the year exceed \$150,000 or if the organization uses a paid professional fundraiser who raises contributions in excess of \$25,000, it must submit an independent financial audit by a certified public accountant to the Attorney General’s Office.

Some organizations qualify for an exemption from these requirements and upon filing for such with the Attorney General’s Office, may be exempt from annual registration. Exempt organizations include churches, other religious organizations, and organizations that do not receive an excess of \$15,000.00 a year in contributions. For further information, see <http://www.ag.state.il.us/charities/index.html>.

#### **IV. Operating Nonprofit Organizations D. Operating Nonprofit Organizations**

*A. What are the responsibilities of the board of directors?*

The board of directors is directly responsible for the general management and control of the organization. Specifically, the organization will determine and implement the corporation's organizational purpose and mission. The board usually selects the organization's executive officers and staff; supports, reviews and evaluates their actions; provides organizational planning; and maintains the organization's financial well being. In furtherance of these responsibilities, every director on the board should act in an ethical manner by complying with all laws and regulations and always acting in the best interest of the organization and the public. For further information, please see Illinois Nonprofit Principles and Best Practices at <http://www.donorsforum.org/publictrust/principles.html>.

*B. How often does the board need to meet?*

Best practices suggest that the board of directors should meet at least once a year to elect officers, discuss the annual reports of the officers and committees, and approve the organization's prior year's actions. Most organizations elect to meet more than once a year. Most often, the board will meet quarterly or even once a month if there is substantial business to attend to. The agendas for these additional meetings will often be prearranged in accordance with an organization's bylaws but often, additional topics or issues may be raised during these meetings as well. Organizations can choose in their bylaws, how formal or informal the procedures for the meetings will be. No matter how the organization elects to conduct its meetings, it will be important for the organization to maintain consistency in the procedures for its meetings.

*C. How will the board make decisions?*

For an action to be resolved by the board, two conditions must exist. First, there must be a quorum of directors present at a meeting. That is a fixed percentage of the whole board must attend a meeting to conduct business. Usually a majority of directors will constitute a quorum (i.e. 50% plus one person). The second condition to pass a resolution is that a certain percentage of directors must affirm a matter of business. The bylaws of the organization should describe the necessary quorum as well as the "manner of acting" (i.e. the minimum number of votes required to pass a resolution). Most often a favorable vote of a majority of directors is required. For special resolutions such as amending the bylaws or selling corporate property, a super majority of directors may be required to pass the resolution.

*D. What is a conflict of interest and what does my organization do if it arises?*

A conflict of interest arises when an officer or director's business or personal interests are potentially at odds with the interests of the organization. Potential conflicts encompass transactions and misusing the organization's information or opportunities. These can be financial or nonfinancial. To help prevent conflicts of interest, an organization should adopt a conflict of interest policy within its bylaws that identifies conflict of interest situations, and outlines the steps necessary to disclose and resolve them. Generally, the interested director or officer must fully disclose the potential conflict and then excuse him or herself

from voting in any decisions and actions related to the conflict.

*E. What's the difference between directors and officers?*

Directors are elected or appointed to serve on the board as the principal people responsible for governing the organization. The officers are specific positions such as president, vice president, secretary, and treasurer. Directors typically hold these officer positions and may simultaneously serve in more than one office. Generally, it is good to have the offices of president and secretary held by different persons. The board of directors annually decides who will serve in the different positions of office. The bylaws may provide a longer term of office or the term may be indefinite (i.e. until the officer resigns or is replaced).

*F. What are the officers responsibilities?*

The officers' responsibilities should be described in the organization's bylaws. Generally, the president is responsible for guiding the overall mission of the organization and running the day-to-day affairs of the organization. He or she is also responsible for presiding at meetings of the board of directors and making sure the meetings are conducted properly. The secretary is responsible for managing the corporate records which may include taking minutes for the meetings of the board of directors and for posting the agendas for the meetings in accordance with the organization's bylaws. The Treasurer is responsible for overseeing the organization's finances, for maintaining accurate records, and disbursing funds. In addition to these general responsibilities, the board of directors or the organization's bylaws may assign additional responsibilities to each officer. Depending upon the nature of the organization there may be other offices provided in the bylaws. The names of the officers may be more creative. For example, one association of nautical professionals included specific officers designated "skipper", "first mate", "bosen", and "bursar". These designations are both clever and legal. However, they often need to remind their banker that the skipper is the president.

*G. May the organization compensate directors and officers?*

Organizations may compensate directors and officers for their services to the organization. However, the complete compensation package an organization provides a director or officer must not be unreasonable or excessive. To assure reasonableness, the organization should review the amount and types of compensation received by other directors or officers in similar nonprofit organizations in the same geographic region. The number of hours worked is also an important factor. If the officer or director's compensation is unreasonable or excessive, it may be engaging in what is referred to as excess private benefit and may expose the organization and the employee to unwanted attention from the IRS as well as the Attorney General's Office. Generally, charitable organizations have volunteer directors because of restrictions imposed by the funding community. It is difficult to raise charitable donations if the directors are compensated. However, the laws of Illinois do not specifically prohibit reasonable compensation paid to directors if necessary. It should be noted that such payment must be

reported as taxable compensation and disclosed on the IRS Annual Report Form 990 discussed below.

*H. Are there limitations on the methods my organization uses to fund-raise?*

An organization that conducts activities that are unrelated to its tax-exempt purposes will be required to pay taxes on its profits. As the organization moves outside the generally accepted methods of soliciting funds and into more business-like ventures, the organization must make sure its activities are substantially related to its tax-exempt purpose or be willing to pay what is referred to as an “unrelated business income tax” (U.B.I.T) on its profits at the federal and state income tax level.

*I. What happens if my organization dissolves?*

The Secretary of State may “administratively” dissolve any domestic corporation that fails to file its annual report and/or fails to appoint and maintain its registered agent in the state. The Secretary of State will send a notice of delinquency to the organization’s principal officer. If the organization does not respond within ninety days, the Secretary of State will dissolve the corporation by issuing a certificate of dissolution. Once this occurs, the organization may no longer carry on its affairs. An organization that has been administratively dissolved may, within five years of dissolution, file an application for reinstatement with the Secretary of State and by filing the organization’s current and past due reports.

If an organization chooses to voluntarily dissolve, it must adopt a plan of dissolution to distribute all remaining assets in accordance with the dissolution language set forth in its bylaws and/or articles of incorporation. Generally, the organization must pay off all liabilities and obligations and transfers all assets held for its charitable purposes to organizations engaged in activities that are substantially similar to the dissolving organization. The organization will also need to file articles of dissolution with the Secretary of State’s office. If the organization files an annual report with the IRS or Attorney General, a report marked “final” must be filed in a timely manner.

*J. What types of insurance should my organization have?*

There are many types of insurance related to nonprofit organizations. First is directors and officers insurance (“D&O”). This protects the organization against a legally actionable breach of duty by the directors and officers and will pay for actual or alleged wrong decisions. However, D&O insurance will not pay for criminal acts, bodily injuries, or property damage. Second, property and casualty insurance will protect the organization from liabilities involved with operations, personal injury, employee negligence, and property damage. Finally, professional liability insurance protects the organization from liabilities caused by professionals and its staff. Depending on the charitable activities the organization plans to engage in, additional insurance may be needed for transportation, computers, and employment. Many organizations implement an umbrella insurance policy in addition to these separate policies.

*K. What are the fiduciary responsibilities of the organization’s directors and*

*officers?*

An organization's directors and officers serve in a "fiduciary" capacity because they hold the assets of their organization in trust on behalf of the public. While some volunteers treat these responsibilities lightly, a lapse in responsible behavior can bring serious charges and possibly personal liability. Thus, directors and officers should take special precaution to three basic areas of fiduciary responsibility.

1. The "Duty of Care." A director or officer must exercise a "duty of care" and diligence and to give informed and prudent attention to all affairs. Directors and officers should beware of the following: mismanaging or wasting corporate financial assets; negligent maintenance of corporate property; negligent supervision of charitable services; publication of slanderous or libelous statements; failure to withhold or collect or remit taxes; wrongful treatment of employees; defaulting on commercial contracts; improperly distributing corporate assets upon dissolution; making improper loans to corporate directors or officers; and failure to exercise responsible financial management.
2. The "Duty of Loyalty." This requires honesty, good faith, fairness, and avoidance of conflicts of interest (described in detail in Question Four above).
3. The "Duty of Obedience." Directors and officers comply with a "duty of obedience" to the organization's purposes, bylaws, and other official policies. Thankfully most of these items may be considered a matter of common sense.

*L. What types of records should the organization keep and for how long?*

The organization should always maintain its corporate documents, documents relating to tax status, financial statements, recent annual reports, and copies of the organization's recent newsletters, journals, or other publications. If the organization has employees, it should maintain payroll and other personnel records relating to employment and any pension or retirement plans.

*M. Does my organization need an auditor/CPA firm?*

as Unless the organization normally receives more than \$150,000 in gross revenue discussed below, hiring an accountant for an independent audit is not required. However, supplying the public with an independent audit of the organization provides donors with specific information on how their donations were used and notifies donors and the public that the organizations' financial records are being properly maintained. For an organization that normally receives more than \$150,000, an audited financial statement must be included with the Annual Financial Report filed with the Illinois Attorney General's Office.

*N. What steps should my organization take before accepting volunteers?*

It is generally advisable to follow the same rules and guidelines that apply to paid employees when deciding to accept volunteers. The organization should interview the volunteers. For positions that require direct contact with children or other vulnerable populations, organizations should conduct a criminal background check for its potential volunteers. The organization should expressly define the responsibilities and activities in which the volunteer is authorized to engage.

*O. Is the organization liable for its volunteers?*

While Illinois law shields individual officers, directors, and other non-compensated agents of organizations from liability in limited situations, an organization generally remains liable for the negligent actions of its volunteers. Accordingly, organizations must exercise reasonable due diligence in accepting volunteers, defining their roles and responsibilities, and overseeing their activities. Organizations that are engaging in high risk activities, such as transporting children, should be especially cautious in defining the activities the organization authorizes the volunteer to engage in.

Volunteer officers and directors should be conscious of their fiduciary responsibilities (see Question J) and exercise prudence and due diligence in their roles as officers and directors. An organization may choose to adopt indemnification provisions into its bylaws to protect its volunteers and obtain adequate insurance to mitigate both the organization and its volunteers' liability.

**V. Regular Reporting Requirements**

*A. What are my organization's ongoing federal reporting requirements?*

Once an organization has filed a 1023 Application with the Internal Revenue Service (see Part III, Question A), the organization will receive a determination letter detailing the organization's future reporting requirements. Unless the organization is a church or defined by the IRS as closely affiliated with a church, it will be required to file IRS Form 990 annually. The IRS Form 990 contains the organization's revenue and expenses, information related to an organization's directors, officers, and highly compensated employees, and further information on the organization's charitable activities. The Form 990 is due on the fifteenth day of the fifth month following the close of the organization's fiscal year.

*B. What are my organization's ongoing state reporting requirements?*

In addition to annually registering with the Illinois Attorney General's Office, an organization must also file an annual report with the Illinois Secretary of States' office to keep the corporation in good standing. The annual report contains the names of the officers and directors of the corporation or company, and is due before the first day of the corporation's anniversary month each year. Finally, the organization must file a Form AG 990-IL, Illinois Charitable Organization

Annual Report. This report must be accompanied with the IRS Form 990 and submitted to the Attorney General's Office within six months of the organization's fiscal year end.

*C. What are the requirements regarding the public inspection of returns requirements?*

All organizations must allow members of the public to inspect its 1023 application, the supporting documents, and any letter or document issued by the IRS in connection with the 1023 application. In addition, the public must be able to inspect the organization's annual IRS Form 990 returns for the last three years. If someone requests a copy by mail, you must provide a copy of the requested documents by return mail but may charge a small fee for your copying and mailing expenses. Many organizations choose to post their 1023 Application and IRS Form 990 returns on their websites.