

CLEARY GOTTLIB

D.C. Nonprofit Formation & Governance

Part 1

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In partnership with the D.C. Bar Pro Bono Center



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Overview

PART 1

SECTION 1 Forming a Nonprofit Corporation

SECTION 2 Understanding Nonprofit Governance

SECTION 3 Exploring Nonprofit Best Practices

PART 2

MARCH 9, 2022 Federal & Local Tax-Exempt Status

Limits of This Presentation

This presentation reviews general nonprofit formation and governance principles and, where needed, refers to D.C. law.

- In the United States, each state has its own set of laws. Be sure to check your state laws to determine the options and requirements with respect to entity formation and governance.
- The information covering federal tax-exempt status will be relevant to all nonprofits, but your particular jurisdiction may also have state and local tax-exempt status provisions.

This presentation does not fully address the many other legal issues that may be relevant to nonprofits, including:

- employment law matters
- intellectual property laws
- complex ownership structures
- regulation of nonprofit relationships with for-profit entities
- fundraising rules and regulations in each state
- lobbying and campaign activity restrictions

Initial Checklist

FORM A LEGAL ENTITY

Incorporate a legal entity and prepare governance documents under the relevant state laws.

OBTAIN AN EIN

Obtain an Employer Identification Number (“EIN”) from the IRS so that you can open a bank account.

APPLY FOR TAX- EXEMPT STATUS

Prepare and submit your applications for federal, state and local tax-exempt status.

APPLY FOR A BBL

Nonprofits in D.C. must apply for and receive a basic business license (BBL) with a “Charitable Solicitation” endorsement before they can legally solicit contributions from D.C. residents.

CONSIDER OUT-OF-STATE AUTHORIZATIONS

Apply for authorization to do business and to solicit charitable contributions in any relevant jurisdiction outside your home state. D.C. nonprofits should likely be licensed in Maryland and Virginia.

1. Forming a Nonprofit Corporation

What is a nonprofit?

1 **A State Entity:** An organization formed under state law that does not operate for the purpose of generating profits for private individuals

- Under the Internal Revenue Code (“IRC”), a tax-exempt organization can be a corporation, a trust, a limited liability corporation, or an unincorporated business association. However, nonprofits are usually formed as nonprofit corporations.
- Nonprofit corporations in D.C. are governed by the D.C. Nonprofit Corporation Code.

2 **Tax Exempt:** Once formed, nonprofit organizations may apply for tax-exempt status under Section 501 of the IRC and under applicable state law

- Section 501(c)(3) provides tax-exempt status to organizations organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, to foster national or international amateur sports competition, testing for public safety, or for the prevention of cruelty to children or animals (“exempt purposes”).
- After your organization is classified as tax-exempt under Section 501(c)(3), the D.C. government requires you to complete additional filings in order to operate as tax-exempt in D.C.
- This is covered in Part II of the presentation.

Pros and Cons of Nonprofit Formation

PROS OF NONPROFIT FORMATION

- Offers limited liability to directors, officers and employees
- May attract funding from grant-making institutions and donors seeking tax deductibility
- Will be exempt from paying taxes on most income
- Formalizes structure and operations, which may attract better talent and committed directors

CONS OF NONPROFIT FORMATION

- Can be costly to establish
- Requires ongoing compliance with federal and state filings and governance obligations
- Cannot engage in political campaign activity and subject to restrictions on lobbying
- Finances subject to public disclosure
- Typically reliant on volunteer board members
- Reliant on competitive funding streams
- May be constrained by limited resources
- Depending on jurisdiction, may be difficult to dissolve

Alternatives to Nonprofit Formation

FIND A FISCAL SPONSOR

- Partner nonprofit permits you to rely on its tax-exempt status, while supervising application of charitable funds to your mission
- Can be short-term or long-term
- Can take many contractual forms (usually a grantee-grantor or embedded program)
- Will usually charge a fee of 5%-10% of donations
- Will typically assist with administrative support and reporting requirements

VOLUNTEER

- Commit to a long-term relationship with an organization whose mission aligns with your vision and save hassle of nonprofit operations

CROWDFUNDING

- Permits you to raise funds for individuals
- Time-limited commitment
- Must ensure no negative personal tax consequences

FORM A FOR-PROFIT

- Start a profit-driven business that commits a portion of its proceeds to charity
- Think Newman's Own or Tom's Shoes, many other examples

START A LOCAL CHAPTER

- Launch a local chapter of a larger national nonprofit
- May be subject to restrictions on activities and membership
- Offers established branding

Formation Considerations

The first step is to consider the type of legal entity as well as where and when you should form.

TYPE OF ENTITY

- Typically, nonprofits are formed as corporations
- Some states permit or require nonprofits to form as other types of entities (e.g., public benefits corporation, LLC), but this is unusual and brings additional governance burdens
- Unincorporated associations may also qualify for tax-exempt status with the right governance documents

WHERE TO FORM

- Your legal entity will be formed under state law
- Typically, you will choose to form in the state in which you plan to conduct the majority of your business or in Delaware if you plan to operate nationally
- Before forming, investigate your state's nonprofit laws and regulations to get a sense of how friendly it is

FORMATION TIMING

- Consider waiting to form your legal entity until you have prepared your tax-exempt status application
- The application process can be lengthy and you will likely want to minimize the gap between formation and applying for tax-exempt status and/or file both within the same calendar year

Regardless of where you incorporate, you can expand your operations to other states. When doing so, you should investigate whether you need to register for authorization to do business in the new state.

Formalizing a Legal Entity

INITIAL STEPS TO FORMATION

1 *Select* a name for your nonprofit.

- Must be distinguishable from the names of other legal entities in your state. Check your state’s online database and consider reserving your name.
- Some states require a corporate indicator in entity name (e.g., “Inc.” or “Corp.”).
- Some states prohibit certain words or phrases (e.g., “doctor” or mortgage”).
- Consider whether similar names are in use in your geographical area or industry to protect against future claims of IP infringement.

2 *File* the certificate or articles of incorporation.

- Your articles of incorporation are the formal record of your nonprofit’s formation under state law. You will file this with your state’s Department of State, or in D.C. with the Department of Consumer and Regulatory Affairs (“DCRA”).
- Certain nonprofit purposes may require additional State agency approvals (e.g., museums or schools).
- Future amendments require board approval (some states may require regulatory approval), and in D.C. notification to DCRA (may need to notify IRS as well).

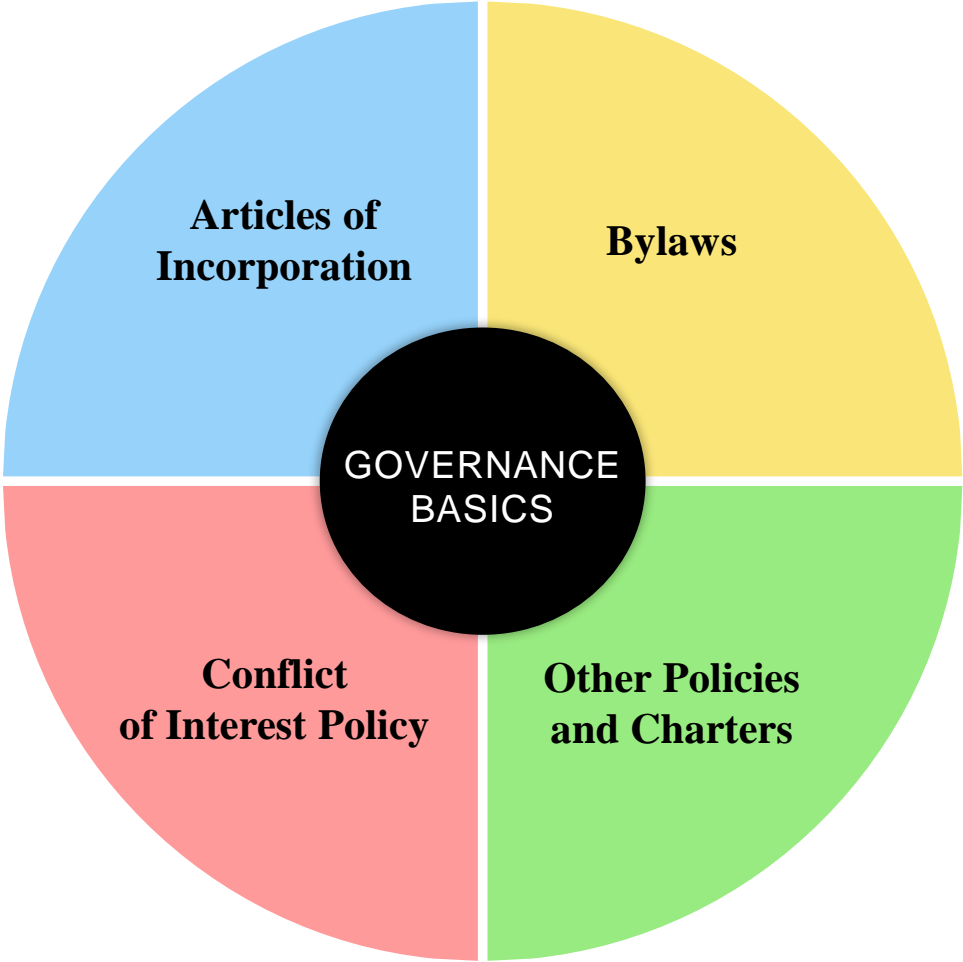
3 *Adopt* required governance documents.

- At a minimum, your nonprofit should have bylaws and a conflict of interest policy, and may be required to have other policies under your state’s laws, including an anti-sexual harassment policy, whistleblower policy, investment policy and others. D.C. does not require any policies, but the core policies are highly recommended.
- You may also want to explore adopting other governance policies and charters to ensure the efficient and effective operation of your nonprofit.

After the entity is established, you will apply for an Employer Identification Number, for federal tax-exempt status, and state/local tax-exempt status.

2. Understanding Nonprofit Governance

Core Nonprofit Governance: Key Documents



Articles of Incorporation

PURPOSE

- Filed with your state’s Dept. of State, or in D.C., the Dept. of Consumer and Regulatory Affairs (DCRA); also called Certificate of Incorporation in other states
- Filing the Articles of Incorporation marks the start of the entity’s existence
- Many states provide sample forms that you can follow, but you must ensure that you include language required by the IRS

CONTENTS

- Must include:
 - name of corporation
 - whether the corporation will have members (see next slide)
 - that the corporation is incorporated as a nonprofit corporation under Title 29 Chapter 4
 - Registered agent’s name and address in D.C.
 - Incorporators’ name(s) and address(es) and must be signed and dated by each
- Should include:
 - Any provisions required by the IRS, e.g., a purpose clause or mission statement
 - Can be general (“e.g., any charitable purpose”) and reference the Bylaws
 - Can be specific, which will ensure that future boards adhere to the mission and may inspire confidence in donors
 - Wherever stated, purpose clause should be consistent across all governing documents and government filings (e.g., Form 1023 and Form 990)
- May include:
 - individuals who will serve as initial directors
 - provisions creating one or more designated bodies

PRACTICAL TIPS

- Consider whether to request expedited treatment when filing to avoid delays
- Typically, should request a certified copy of the Articles for your records
- Filing fees vary across states
 - D.C.: \$80 to file; \$50 to expedite in 3 days; \$100 to expedite in 24 hours
 - Filing by mail may take 6 weeks or more in D.C.

Governance Structure – Members

- A nonprofit may choose to have governing members, but is not required to do so.
- The rights of members are spelled out in the articles of incorporation and bylaws.
- In D.C., the articles must explicitly state whether or not the nonprofit has statutory members

STATUTORY MEMBERS

- The nonprofit equivalent of shareholders, “statutory” members have legal rights under D.C. law, allowing a nonprofit’s constituents to play a role in the nonprofit’s functioning without elevating them to full director status.
- Typically, statutory members elect the board of directors and have a say in major corporate decisions.
- Statutory members can significantly increase an organization’s administrative/compliance burden and create control issues.
- Because of these challenges, only a small minority of modern nonprofits have statutory members.

NOMINAL MEMBERS (THINK MUSEUMS!)

- An alternative to statutory members that does not give rise to many of the aforementioned issues.
- Nominal members typically have no governance or control rights.
- The complexity comes with defining who is a member and keeping accurate membership lists.

Bylaws

PURPOSE

- Set of agreed-upon rules and procedures governing internal operations
- Directors and senior management should refer to bylaws regularly
- Should be reviewed and updated regularly to ensure legal compliance

CONTENTS

- Sets forth governance rules and procedures, including with respect to:
 - Existence of statutory members
 - Purpose clause (must be consistent with articles)
 - Number of directors, method of election, term limits
 - Board meetings (including remote/telephonic meetings), quorum, and voting
 - Appointment of officers and committees (In D.C., a nonprofit must have a chief management officer, a chief financial officer, and a secretary)
 - Indemnification provisions
 - Means of amending the Articles of Incorporation and/or bylaws
 - Dissolution procedures
- State law may set minimum requirements for many governance provisions

PRACTICAL TIPS

- View the bylaws as a “living” document that can be regularly amended as needed to reflect the board’s preferences and to comply with best practices

Conflict of Interest Policy

PURPOSE

- Helps avoid the appearance or actuality of private benefit to individuals who are in a position of substantial authority
- Outlines procedures for directors to identify and assess potential conflicts that exist between their own interests (or those of a related party) and the interests of the nonprofit

CONTENTS

- Typically includes:
 - Definitions of conflict, financial interest, and interested or related party
 - Procedures for disclosing a potential conflict
 - Procedures for assessing a potential conflict (including permitting the interested party to provide information to the board, investigating other options, or relying on outside experts)
 - Procedures for determining whether a conflict exists (interested party must leave the room during voting) and recordkeeping
 - Procedures for discipline and ratification
- Can be accompanied by an annual disclosure form (directors, officers, senior staff)

PRACTICAL TIPS

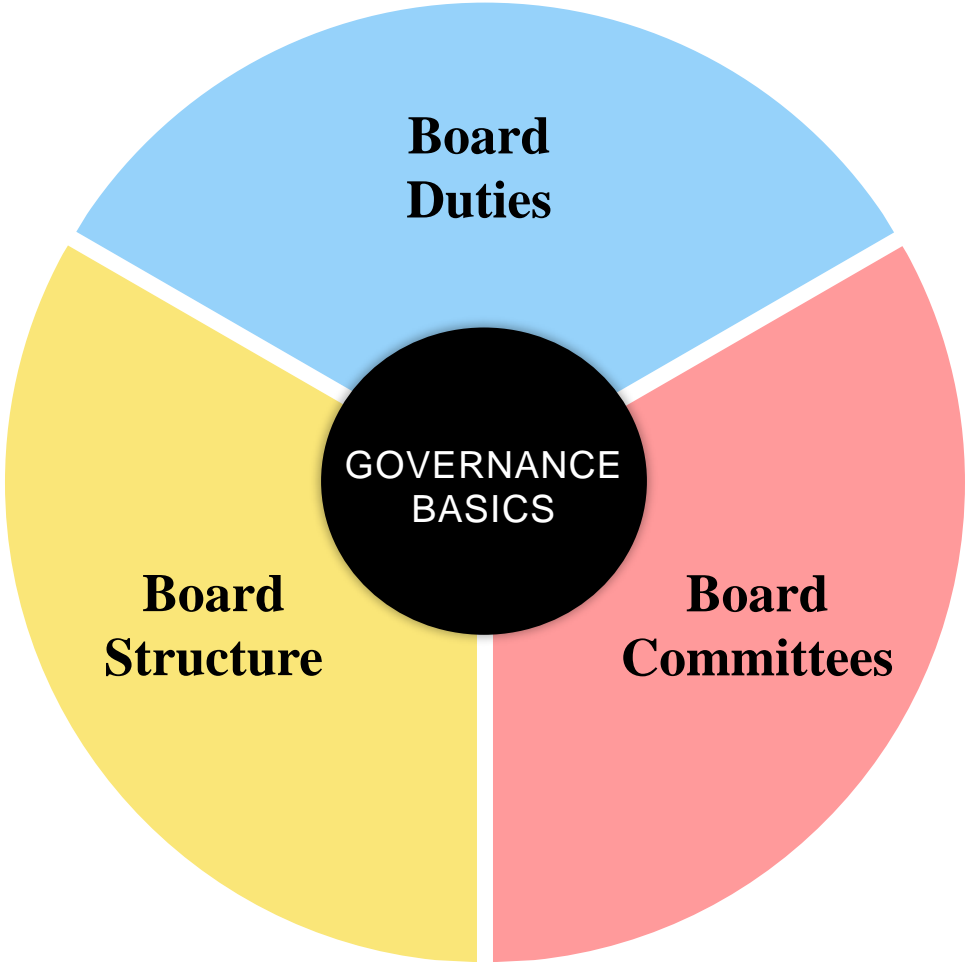
- Not legally required in many states including D.C., but is strongly recommended and the IRS does ask about its existence
 - The IRS is putting a great emphasis on properly managing conflicts of interest and wants every nonprofit to have a written policy
- Some states have detailed legislation setting forth conflict requirements

Other Key Governance Policies

TYPICALLY NOT LEGALLY REQUIRED, BUT MAY BE ADVISABLE:

1	<i>Whistleblower Policy</i>	<ul style="list-style-type: none">— Advisable (IRS wants all nonprofits to have a whistleblower policy), and may be legally required, for larger nonprofits— Protects individuals who report unethical or unlawful practices, emphasizing financial impropriety— Prohibits retaliation for good-faith reports (this must be specified in policy)— Sets forth reporting and investigation procedures (must identify to whom individuals may report)
2	<i>Record Retention Policy</i>	<ul style="list-style-type: none">— Advisable (IRS wants all nonprofits to have a record retention policy), and may be legally required, for larger nonprofits— Policy to determine for how long documents are kept and methods for document destruction
3	<i>Investment Policy</i>	<ul style="list-style-type: none">— Written policy for investing excess cash and other funds— Establishes parameters for risk tolerance and evaluation of investments, as well as delegation of investment management— Should be reviewed regularly by the board— Implementation may be delegated to an Investment Committee— Supports effective exercise of fiduciary duties
4	<i>Compensation Policy</i>	<ul style="list-style-type: none">— Compensation decisions will be presumed reasonable if based on objective, documented comparability data (regulated by IRS)— Sets forth documentation and voting requirements
5	<i>Board Commitment Statement</i>	<ul style="list-style-type: none">— Trend toward elimination of “give/get” policies in an effort to diversify boards through recognition of the many ways directors can contribute

Core Nonprofit Governance: The Board



Governance: Board Duties

- The board of directors is responsible for overseeing the affairs of the organization.
- Board members are collective and individual fiduciaries and must exercise their duties in a manner consistent with their fiduciary obligations.
- Fiduciary duties are the legal standards that govern how directors engage with the organization they serve.
- Directors must exercise care in overseeing the activities and finances of the organization, must devote themselves to the organization and its interests exclusively, and must ensure that the mission and purposes of the organization are pursued and that all activities are conducted in compliance with law.

CARE

- Must pay attention, be informed, be diligent, ask questions, use common sense and attempt to make sound and informed decisions about the nonprofit's finances and operations

LOYALTY

- Must pursue the interests of the organization (including its mission and well-being) with undivided allegiance; must put the corporation's interests above any individual interest

OBEDIENCE

- Must act in accordance with the purpose clause as set forth in the Articles of Incorporation and IRS Form 1023, and comply with applicable federal and state law

DUTY TO INFORM

- In D.C., there is a duty to disclose information that is material to decision-making or oversight functions of the board

TONE AT THE TOP

- Through their board leadership, directors can foster an ethical climate whereby everyone – including directors, employees and volunteers – acts in a manner that upholds the highest ethical standards
- It is important that the Board foster this expectation for themselves and others

The business judgment rule may provide a defense from liability where these duties are satisfied, but nonprofits should also purchase Director & Officer (D&O) insurance.

Governance: Board Structure

SIZE

- In D.C., a nonprofit must have a minimum of three directors; there is no maximum.
- The number of directors should be authorized in the Bylaws.
- The “right” size of a nonprofit board depends on the needs and circumstances of each nonprofit.

INDEPENDENT DIRECTORS

- While not required under D.C. law, IRS Form 990 asks about the number of independent directors as an indicator of robust board governance.
- Nonprofits should strive to have a majority of independent directors on the board.
- “Independent” directors (a) do not receive compensation from the nonprofit (either as staff or independent contractors over a certain threshold) and (b) do not engage in transactions, either personally or through controlled entities, with the nonprofit and any related organizations exceeding \$10,000.
- Both rules apply to the directors and to their family members; e.g., if a director’s spouse or child is an employee of the organization, that director is no longer “independent”.

MECHANICS

- **Meetings:** How often does the board meet? (Best practice at least quarterly)
- **Notice:** An organization’s bylaws typically set forth notice requirements for regular and special meetings.
- **Quorum:** 90% of the directors should attend board meetings; bylaws should require at least 50%.
- **Minutes:** D.C. law requires nonprofits to prepare minutes, while the IRS wants nonprofits to prepare board minutes “contemporaneously” (within the later of 60 days or the next board meeting). The organization must disclose whether it contemporaneously prepares its minutes on the Form 990.
- **Voting:** The board may only act at a validly called board meeting at which a quorum is present. It has no authority to act outside a board meeting, with the exception of a unanimous written consent.

Governance: Committees

D.C. law (and most states) permit the board to form board and advisory committees

The board can delegate to **board committees** the authority to make final decisions on behalf of the board

Only directors may serve on board committees

In D.C., the creation of the committee and the appointment of committee members must be approved by a majority of all directors then serving on the board

The board may also appoint **advisory committees** that make recommendations to the board, but not final decisions (if a committee can make final decisions, it is a board committee and can only be comprised of directors)

An advisory committee can be authorized with the same level of responsibility as a nonprofit staff member

Governance: Financial Oversight

FINANCIAL OVERSIGHT

- The board is responsible for the financial oversight of the organization, including:
 - establishing an audit committee (a board committee)
 - ensuring tax filings are timely and accurately made
 - reviewing IRS Form 990 in advance of filing
 - reviewing executive compensation decisions
 - establishing and monitoring travel and expense reimbursement policies
 - overseeing fundraising practices

FINANCIAL DISCLOSURE

- The board must also oversee the financial reporting of the organization. On the Form 990, the nonprofit must disclose:
 - whether the board received a copy of the 990 before it was filed with IRS and
 - the process by which the directors and management reviewed the Form 990, either before or after it was filed, including who conducted the review, when they conducted it, and the extent of the review.
 - If no review was conducted, the nonprofit must disclose this.

AUDIT COMMITTEE

- Appointed by the board – usually, independent directors with financial expertise
- The audit committee is responsible for:
 - selecting the external auditor
 - supervising the audit process – setting audit standards and resolving audit conflicts between the auditor and management
 - monitoring internal financial controls

3. Exploring Nonprofit Best Practices

Core Best Practices

- ✓ Develop a Board of Directors that will engage with and advocate for the nonprofit
- ✓ Review governance documents and financial management practices regularly to ensure legal compliance with latest changes in laws
- ✓ Commit the nonprofit's mission to writing and keep it at the core of every decision
- ✓ Ensure the nonprofit serves a public benefit, rather than a private benefit (and that any private benefit is “incidental” to its activities)
- ✓ Ensure compensation paid to any person who provides services to the nonprofit is fair, reasonable and in the best interests of the organization
- ✓ Maintain adequate insurance coverage, including general liability, D&O, property, auto and other necessary coverage

Best Practices: Key State Filings

There are several state filings your organization may need to satisfy.

D.C. FILINGS

- In order to legally solicit contributions in D.C., you must receive a basic business license (“BBL”) for the charitable solicitation category.
 - \$412.50 application fee for a two-year license that must be renewed every two years.
 - Must already be incorporated, be classified as tax-exempt by the IRS, completed tax registration in D.C., and, if incorporated in D.C., have obtained a Certificate of Occupancy or Home Occupation Permit for physical premises
 - The application fee is waived for organizations that have not and do not expect to receive more than \$25,000 in annual gross contributions.
 - Organizations that solicit solely from their own members, engage solely in workplace giving campaigns, and religious organizations that solicit solely for educational or religious purposes are exempt from licensure.
- The DCRA Two-Year Report is due April 1 (of the year after incorporation) and every two years thereafter.

OTHER STATES

- Most states require organizations to register with the state before soliciting donations from individuals, foundations or businesses located in the state.
- This includes Virginia and Maryland, in which most D.C. nonprofits should be licensed.
- There are exemptions, including for small, religious organizations, etc.
- Forty jurisdictions, including D.C., VA and MD, accept the Unified Registration Statement, in lieu of the state-specific form.
- Active online solicitation, e.g., through email, is subject to the same rules as solicitation through the U.S. mail.

Best Practices: Other Filings

There are also federal filing requirements that your organization may need to satisfy.

FEDERAL

- IRS: Annual Return Form 990
- Check your organizations 501(c)(3) status here:
<https://apps.irs.gov/app/eos/>

AMENDMENTS

- Changes to the organization's mission and/or key activities should be reflected in its articles and bylaws and reported to relevant government authorities.
- Changes to the articles must be registered with the DCRA.
- Significant amendments to the organization's articles and bylaws and/or significant changes in the organization's programs/services are reported to the IRS via Form 990 or 990-EZ.

Best Practices: Public Inspection

Public Inspection

Nonprofits must make the following documents available for public inspection at their offices upon in-person request and upon mail/email request:

- Their last three annual Form 990s/990-EZs, including schedules and attachments, and 990-Ts (if applicable)
- Their original IRS application for exemption (Form 1023/Form 1023-EZ)
- Their IRS exempt status determination letter

Public Availability/Copying Obligation

Nonprofits are also required to make copies of these documents available to the public.

Documents that are posted publicly online (*e.g.*, IRS website, GuideStar) satisfy this requirement

Documents that are not online must be provided in hard copy upon request (nonprofit can charge the requester copying and postage).

Compliance

Many nonprofits are unaware of these public inspection requirements and have not trained their directors/staff accordingly.

Failure to comply can trigger daily IRS fines.

If a nonprofit cannot find a copy of its Form 990 or 1023 exemption application, it can request a copy from the IRS using Form 4506-A.

Additional Resources

D.C. Bar Pro Bono Center: Contact

— Darryl Maxwell: dmaxwell@dcbar.org

— Jason Qu: jqu@dcbar.org

D.C. Bar: Help for Nonprofits

— <https://www.dcbar.org/pro-bono/free-legal-help/help-for-nonprofits>

Exponentum: Powering Business Law for Nonprofits (Lawyers Alliance)

— <https://lawyersalliance.org/exponentum>

IRS Publication 557: Tax-Exempt Status for your Organization

— <https://www.irs.gov/pub/irs-pdf/p557.pdf>

Bolder Advocacy: Enabling Nonprofit Advocacy

— <https://bolderadvocacy.org/>



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