

Alternatives to Forming a Charitable Nonprofit

A Start-Up May Not Be in Your Client's Best Interests

By Gene Takagi and Emily Chan

Lawyers retained to assist in the formation of a charitable nonprofit should consider whether forming a nonprofit is in the client's best interests. Absent sufficient research by the client and a good plan for continued viability, the lawyer may best serve the client by introducing alternatives to forming a nonprofit, which may include (1) an alliance with an existing nonprofit, (2) fiscal sponsorship, or (3) a donor-advised fund.

Prior to forming a nonprofit, lawyers and their clients should consider the extremely competitive landscape—the vast majority of new nonprofits will fail, become dormant, or operate in financial distress. Stan Madden, director of the Center for Nonprofit Studies at the Hankamer School of Business at Baylor University, estimated that only one-third of nonprofits survive beyond five years. Ron Mattocks, author of *Zone of Insolvency: How Nonprofits Avoid Hidden Liabilities and Build Financial Strength*, asserts that as many as one-third of the nation's 1.4 million registered nonprofits operate in the zone of insolvency.

The mechanics of forming a nonprofit and obtaining tax-exempt status

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may present little challenge for a lawyer or a sophisticated client. However, funding, compliance with myriad requirements, and operating a viable nonprofit can be exceptionally difficult, even with the best of intentions and initial seed capital. Typically, when the economy is not strong, the competition for funds and other resources can be fierce due to an increasing pool of nonprofits, the growing need for services, and diminishing resources. If a nonprofit is insufficiently prepared to compete and operate in such an environment, the end product may be gross inefficiencies, frustrated founders, disillusioned donors, and fewer resources ultimately reaching its intended beneficiaries.

Sufficient Research

Individuals considering forming a charitable nonprofit should research not only how to start a nonprofit but also whether a new nonprofit would be the best vehicle to further their charitable objectives from the public's perspective. Researching and writing a business plan is a prudent early step. The plan should define the nonprofit's mission and identify its core activities, potential supporters, and targeted beneficiaries. It also should contain an assessment of the nonprofit's environment, including its potential allies and competitors, and a projected multiyear budget. The exercise of preparing a plan will likely require market research and help determine whether or not there are already one or more nonprofits with similar goals.

Before a decision is made to form a nonprofit, lawyers should ensure that the founders understand the fundamentals of operating as an organization exempt under section 501(c)(3) of the Internal Revenue Code (the Code), including the prohibitions against private inurement and private benefit. Too many founders believe that they are entitled to control the nonprofits they create and can leverage such control to their personal advantage with little restriction.

Under the private inurement doctrine, a nonprofit may not permit any part of its net earnings to inure to the benefit of a person having a personal and private interest in the organization's activities (i.e., an insider such as a director, officer, or key employee). An organization that engages in an inurement transaction may face revocation of its exempt status. Under the similar, but broader, private benefit doctrine, a nonprofit may not confer nonincidental benefits on individuals for the benefit of private interests. Accordingly, any benefit conferred upon an individual must be incidental, quantitatively and qualitatively, to the furthering of the organization's exempt purposes. Where an excess benefit is conferred upon a person who is in a position to exercise substantial influence over the affairs of the organization (e.g., a director, officer, or other disqualified person), the transaction may be subject to excise taxes under section 4958 of the Code.

Founders also should be cognizant of the ongoing obligations of a

10 Questions Your Clients Should Answer Before Forming a Nonprofit

1. What will be the nonprofit's charitable purposes?
2. What will be its core activities?
3. Who are its intended beneficiaries?
4. Are there existing nonprofits with a similar mission, and, if so, have you discussed your ideas with them?
5. Can your mission be furthered more effectively and efficiently by an existing nonprofit?
6. Can you attract sufficient resources to start and operate a new nonprofit?
7. Have you drafted a business plan (including a three-year projected budget)?
8. Are you familiar with what it takes to start and run a nonprofit in compliance with the laws and best practices?
9. Have you considered alternatives to forming a new nonprofit, such as fiscal sponsorship and donor advised funds?
10. Whose help will you need to form the nonprofit and get it running?

nonprofit, including periodic filings with the Internal Revenue Service (IRS) and various state authorities. Those who will serve on the board of a nonprofit corporation should know the basics of nonprofit corporate governance. In addition, if there are to be employees, the nonprofit must be prepared to meet the obligations of a new employer.

Well-prepared founders increase their chances of creating a sustainable nonprofit organization. Lawyers advising ill-prepared, would-be founders may do a great service to their clients and to the broader public by educating them and sending them back to do their homework before they decide whether to proceed with the formation of a nonprofit.

Plan for Viability

A great plan for providing services to members of a charitable class is reason for excitement, but in and of itself, it is not a sufficient reason to form a nonprofit. There also needs to be an achievable plan for acquiring resources (human, financial, and other) required to provide those services and operate the nonprofit over a period of time. Such plan should include sources of adequate start-up capital, an initial

governing body, marketing strategies, and targets for ongoing support and some long-range ideas.

While it may not be the lawyer's role to judge the relative viability of a contemplated nonprofit, it is usually clear when a client is relying on an unrealistic expectation that donors and funders will find and support the new nonprofit with little effort or planning. Generally, in such case, the lawyer should recommend that the client either postpone forming a nonprofit or consider one of the alternatives outlined below.

Use of an Existing Nonprofit

According to the National Center for Charitable Statistics, the number of 501(c)(3) organizations has increased by over 70 percent between 1996 and 2006. In the one-year period from October 1, 2006, through September 30, 2007, the IRS received over 85,000 applications for recognition of exemption under section 501(c)(3).

A critical mistake made by many founders of charitable nonprofits is their failure to communicate with, and examine, the existing nonprofits in their space. With roughly 1.8 million domestic nonprofits (IRS 2008 Annual Report), chances are high that

an organization with substantially similar goals to the one contemplated already exists. Working or collaborating with an existing nonprofit can leverage significant advantages while mitigating many of the risks that can be a fatal blow to the survival of a new nonprofit.

Working with an existing nonprofit as an employee or volunteer may be especially valuable to an individual who lacks experience, nonprofit business sophistication, and/or resources. When appropriate, lawyers should make their clients aware of the following benefits of working with an existing nonprofit:

- Avoidance of start-up costs and administrative burdens of a new nonprofit.
- Increased efficiency in furthering the charitable mission by using an established infrastructure.
- Opportunity to gain experience and expertise in running a nonprofit.
- Development of connections in the nonprofit community.

Collaborating with an existing nonprofit is an alternative that may be considered even where the contemplated charitable idea is not currently being implemented by an existing nonprofit. A nonprofit with a compatible mission may be receptive to implementing and operating a new program, particularly if a volunteer is willing to bring resources to the table. Alternatively, the nonprofit may have institutional knowledge relating to the charitable idea and its implementation. Moreover, the nonprofit may open doors and leverage assets that might not be otherwise readily available, such as

- Existing resources, including staff, volunteers, infrastructure, and systems.
- In-house experience and expertise, which may allow the contemplated program to be launched and operated efficiently and in compliance with the law.
- Donor and business relationships, including with institutional funders, nonprofit leaders, allied organizations, and the media.

- Goodwill, which may provide the program with name recognition and built-in public trust.

Fiscal Sponsorship

Fiscal sponsorship is the term used to describe the relationship between an individual or group of individuals who have initiated a charitable project (the Project) and an existing tax-exempt organization that has agreed to support the Project (the Sponsor). Typically, the Sponsor confers upon the Project the benefit of the Sponsor's tax-exempt status and certain administrative services. However, the precise nature of the relationship, the support provided by the Sponsor, and the rights of the Project's initiators (the Project Initiators) may vary widely depending on the agreement between the parties. A well-drafted fiscal sponsorship agreement is therefore imperative.

Perhaps the most common model of fiscal sponsorship is one in which the Project is housed within the Sponsor, has no separate legal existence, and is operated by the Sponsor's employees and/or volunteers. Greg Colvin, author of *Fiscal Sponsorship: 6 Ways to Do It Right*, describes this model as the Direct Project Model. Contributors to the Project make their gifts directly to the Sponsor. The Sponsor usually retains a portion of the gifts as a fee (5–10 percent is common) and allocates the rest to the Project. The Project Initiators may serve as employees or volunteers of the Sponsor delegated with the responsibility of operating the Project. They also may retain the right to move the Project to another Sponsor or to a new exempt organization created to permanently house the Project. Any such rights should be precisely spelled out in the fiscal sponsorship agreement.

Fiscal sponsorship may provide a Project with immediate tax-exempt status, advantageous treatment as a public charity (i.e., nonprivate foundation) without independently passing a public support test, some degree of administrative support, and a governing body that has a duty to ensure that the Project is operating in compliance with applicable laws. The Project Initiators

must weigh such benefits against a lack of autonomy; their limited control over the Project, which remains under the ultimate control of the Sponsor; and the sponsorship fees.

It is likely that a great majority of individuals and groups interested in forming a nonprofit have never considered, nor even heard of, fiscal sponsorship. Yet, fiscal sponsorship may be a very attractive alternative to formation of a nonprofit, particularly where the sustainability of a separate entity is highly questionable or the charitable endeavor has a relatively short life span. Sponsors often serve as incubators of Projects that later spin off upon a determination by their respective Project Initiators that they can govern

Donor-Advised Funds

A donor-advised fund, first defined in the Internal Revenue Code as a result of the Pension Protection Act of 2006, is a fund or account (1) that is separately identified by reference to the contributions of a donor or donors; (2) that is owned and controlled by a sponsoring organization; and (3) with respect to which the donor or person appointed or designated by the donor has, or reasonably expects to have, advisory privileges with respect to distributions or investments. Individuals contemplating forming a grant-making private foundation may find a donor-advised fund to be a better alternative.

Founders of private foundations will face slightly different challenges from

Additional Resources

Fiscal Sponsorship

- www.fiscalsponsorship.com (San Francisco Study Center)
- <http://foundationcenter.org/getstarted/tutorials/fiscal> (Guide to Fiscal Sponsorship)

Donor-Advised Funds

- www.guidestar.org/DisplayArticle.do?articleId=1092 (New Rules Affecting Donor-Advised Funds)
- www.bostonfoundation.org/Giving/GivingDetail.aspx?id=194 (Donor-Advised Fund/Private Foundation Comparison)

and operate sustainable independent organizations. Lawyers providing counsel to would-be founders of nonprofits who appear inadequately prepared to set up a sustainable organization should inform their clients of the fiscal sponsorship alternative.

Project Initiators that are considering fiscal sponsorship should be very selective in choosing a Sponsor. Sponsors differ widely with respect to charitable mission, services, management oversight, fees, experience, legal sophistication, and their own viability. Nonprofit support centers, community foundations, and the online Fiscal Sponsor Directory produced by the San Francisco Study Center (www.fiscalsponsorsdirectory.org) may be helpful resources for finding a qualified Sponsor.

founders of public charities. Funding may not be a critical issue, but directors, trustees, and managers must deal with additional laws and limitations associated with private foundations. For example, private foundations must (1) pay a 2 percent tax on their net investment income; (2) refrain from acts of self-dealing; (3) meet minimum distribution requirements (generally 5 percent of their investment assets); (4) abstain from excess business withholdings; (5) abstain from jeopardizing investments; and (6) refrain from certain types of expenditures, such as those paid or incurred to lobby, make grants to individuals that do not satisfy certain criteria, or make grants to nonpublic charities other than operating foundations without exercising expenditure responsibility. Moreover,

A Fourth Alternative?

Lawyers may determine for certain clients that the laws applicable to nonprofits and tax-exempt entities are not compatible with the client's plans. For example, the client may be seeking to secure investment capital or earned income from substantial unrelated business activities. Or the client may want rights and control more consistent with that of an owner of a for-profit corporation than a director or officer of a nonprofit. In such cases, a for-profit corporation or limited liability company may be a more appropriate vehicle for the client. If the client desires to form an entity that pursues social goals over maximization of its owners' return on their investments, the new low-profit limited liability company (L3C) may be a viable alternative.

the charitable deduction limits for contributions to a private foundation are lower than those for comparable contributions to a public charity (e.g., the charitable deduction for a contribution of money to a private foundation is generally limited to 30 percent of the donor's adjusted gross income versus 50 percent for a contribution of money to a public charity).

The many benefits for the donor of a donor-advised fund include

- No formation costs.
- Possibility of making immediate deductible contributions.
- More generous deduction limits (because the sponsoring organization is a public charity).
- No administrative, investment, or governance responsibilities (and associated risks).
- No need to provide oversight over grants.

Additional benefits of a donor-advised fund may depend on the nature of the sponsoring organization, which is typically either a community foundation or a public charity affiliated

with a financial institution like Fidelity, Vanguard, or Schwab. Community foundations offer valuable philanthropic guidance to donors and opportunities to participate in community leadership initiatives and events. Financial institutions may offer lower administrative fees and costs.

Perhaps the most important limitation of a donor-advised fund is the donor's lack of legal control after making the contribution. Because the contribution is considered a completed gift at the time of contribution, the donor may be able to take a charitable deduction in the year that the gift is made. However, the trade-off is that the donor may only provide recommendations or advice to the sponsoring organization about potential recipients of grants from the donor-advised fund. While the donor may not have legal control over the fund, it is easy to understand why sponsoring organizations generally make a strong attempt to adhere to their donors' recommendations so long as such grants would be consistent with the sponsoring organization's

exempt purposes and in compliance with the law. Sponsoring organizations that regularly disregard their donors' wishes will soon lose goodwill in their communities and may no longer be competitive as sponsors of donor-advised funds.

Lawyers asked to form private foundations should generally ensure that their clients are aware of, and educated about, the donor-advised fund alternative, particularly where the initial funding is modest. One rule of thumb states that private foundations should not be formed without funding of at least \$2 million. However, this recommendation presumes that such amount will be a one-time contribution to an endowment. It does not recognize the plan of some clients to make regular contributions to the foundation or to give the foundation a limited life span. The better rule of thumb is that a private foundation should not be formed without a strong likelihood that it will distribute at least \$25,000 in annual grants. Anything less may result in inefficient grant-making in light of the costs associated with operating the foundation.

Conclusion

Well-intentioned individuals form too many unsustainable and inefficient nonprofit organizations because of insufficient research or planning. Before routinely facilitating the formation of a nonprofit, in many cases, lawyers may best serve their clients by advising them of possible alternatives.