



Starting a Nonprofit Organization in Arizona

**By Ellis M. Carter
Carter Law Group, P.C.
849 N. 3rd Avenue
Phoenix, Arizona 85003
ellis@carternonprofitlaw.com
(602) 456-0071**

Part I: Starting a Nonprofit Organization in Arizona – Laying the Groundwork

Looking back on my legal career, I realize that too many of the nonprofit organizations I helped to create early on never got off the ground. Today, I consider it part of my responsibility to the potential new client and to the sector to educate would be founders on the realities of the marketplace. What follows is a walk through the typical discussion that I have with potential nonprofit founders.

1. Survey the Landscape. To get a realistic idea of your chances of attracting financial support for your organization, research other organizations that do similar work or serve the population you are planning to serve. If there are others filling the need and filling it well, do you have a plan to deliver services in a new, innovative way? If the need is not underserved and you can't differentiate your organization, it is going to be very difficult to attract funding. Worse, the funding you attract may weaken existing organizations trying to fulfill the same mission.
2. Do Your Homework. To obtain 501(c)(3) status, nonprofits have to present the IRS with a detailed business plan. A business plan is not a mission statement. It is a document that answers what you plan to do, when, where, how, for and by whom and at what cost. Put in writing what your organization will do, where it will operate, its main purpose, its charitable mission and goals, anticipated budgets and any other information that will distinguish the organization. This can present a frustrating chicken and egg problem for many would be founders. If you can't answer these questions in detail, consider whether you are really ready to start a nonprofit organization.
3. Consider Testing Your Idea as a Sponsored Project. Many would be founders turn to fiscal sponsorships to test and/or incubate their programs. The term "fiscal sponsorship" describes an arrangement between a non-profit organization with 501(c)(3) tax exempt status and a project, often a new charitable effort, conducted by an organization, group, or an individual that does not have 501(c)(3) status. Fiscal sponsorship permits the exempt sponsor to accept funds restricted for the sponsored project's purpose on the project's behalf. The sponsor, in turn, accepts the responsibility to ensure the funds are properly spent to achieve the project's goals. This arrangement is useful for new charitable endeavors that want to "test the waters" before deciding whether to form an independent entity as well as temporary projects or coalitions that are looking for a neutral party to administer their funds. In Arizona, both the Arizona Community Foundation and [Technical Assistance Partnership of Arizona](#) offer this service.
4. Build a Board. You will need to find people to work with you and serve on the board of directors. While Arizona law requires only one board member to incorporate, the IRS will likely require additional board members. Generally, for a charitable organization that will fundraise, the IRS wants at least a majority of the directors to be disinterested individuals who are not compensated by the organization and are not closely associated with staff members or others who are compensated by the organization.

Example: If a founder is a paid employee and the founder's spouse is on the board, the organization would need to appoint three unrelated individuals to serve as directors of the corporation. This is not a law but is based on personal experience.

5. Clarify Ownership of Assets. If the organization is a nonprofit, understand that no one person can claim ownership. In Arizona, nonprofit corporations are "non-stock corporations." In other words, there is nothing to own. Control is typically vested in the board of directors and the assets belong to the corporation. Because the directors and founders do not "own" the organization, it cannot be sold when the directors and/or founders wish to leave the organization or retire.

Therefore, if you plan to contribute personal assets, you will want to clarify whether the contribution is a gift or a loan and have the disinterested board members approve the arrangement.

Example: If you contribute seed money and expect to be paid back, enter into a promissory note approved by the disinterested members of the board. Also, intellectual property created by the founder prior to incorporation should be licensed rather than contributed unless the founder intends to give up their rights to the work.

6. Naming the Organization. Before incorporating, the incorporators will need to select a name that does not conflict with an existing Arizona business, regardless of the tax-exempt status of the existing business. Keep in mind that if the name sounds like an existing for-profit or nonprofit business name, the Arizona Corporation Commission may require you to add additional words to distinguish your organization. Once you choose a name, you can check the [Arizona Corporation Commission website](#) to see if the name is available. If the name you have chosen is available and you aren't ready to incorporate, you can reserve the name online for 120 days at a cost of \$10.00 (\$45 if you wish to expedite the reservation). If the organization is ready to incorporate there is no reason to reserve the name, just prepare and file the Articles of Incorporation.

Tip: Ideally, you want a name that: (i) will afford strong federal trademark protection, but will not infringe on anybody's trademark or service mark; (ii) will be easy for your stakeholders to remember; (iii) will describe your mission or services; and (iv) will allow you to obtain a .org or .edu domain name. You can check to see if your corporate name will infringe on a federally registered trademark or service mark by searching your prospective name and variations of the name on the United States Patent & Trademark Office's [searchable database](#).

After considering the above and developing a detailed business plan, the next step is to review the actual mechanics of creating the organization and applying for tax-exempt status.

Part II: Starting a Nonprofit Organization in Arizona - Forming the Entity

Once a nonprofit founder has surveyed the nonprofit landscape and found a legitimate need, developed a detailed business plan, recruited an initial board, decided on an available name, and scraped together some start-up funding, he or she is ready to proceed with forming the entity. In Arizona, it usually makes the most sense to form the entity as an Arizona nonprofit corporation. Very generally, the steps to creating a new nonprofit corporation in Arizona begin with the filing of the Articles of Incorporation.

1. Prepare and File Articles of Incorporation. The filing of the Articles of Incorporation begins the organization's legal existence. The Articles of Incorporation must contain the following information:
 - The name of the corporation that satisfies the requirements of A.R.S. Section 10-3301.
 - The specific purposes for which the organization is being created.
 - A brief statement of the character of affairs that the corporation initially intends to conduct.
 - The name and address of each person who is to serve as a director until a successor is elected and qualifies.
 - The name, street address and signature of the corporation's statutory agent. The statutory agent must reside in Arizona and will receive all legal notices sent to the corporation. If your statutory agent moves out of state or leaves the organization, a new statutory agent must be provided to the Arizona Corporation Commission.
 - The street address of the known place of business for the corporation, if different from that of its statutory agent.
 - The name and address of each incorporator.
 - Whether or not the corporation will have members.
 - The signatures of all incorporators. Only one person is required to be the incorporator.
 - The initial incorporators, directors and officers will also have to complete and file a Certificate of Disclosure with the Articles of Incorporation.

The Arizona Corporation Commission provides sample form Articles of Incorporation and the Certificate of Disclosure in pdf format for a non-exempt nonprofit corporation that will pay federal income taxes. However, the Arizona Corporation Commission does not provide samples appropriate for nonprofits that plan to apply for tax-exempt status. Therefore, *if you are trying to form a nonprofit that will apply for tax-exempt status, do not use the state form.*

A Note about the Arizona Corporation Commission Forms. When relying on the Arizona Corporation Commission form it is important to understand the tax-provisions. Nonprofit corporations in Arizona can be either taxable or tax-exempt. The corporation's status as a nonprofit corporation is a state law designation, not a federal tax designation. If the corporation wishes to apply for tax-exempt status under Section 501(c)(3), specific language must be included in the Articles of Incorporation as follows:

- a. Exempt Purpose. To qualify for tax-exemption under Section 501(c)(3), the Articles of Incorporation must limit the corporation's activities to charitable purposes. The purpose statement should be broad and flexible enough to give the organization room to evolve, without being so all encompassing that it would permit it to engage in non-exempt activities. The exempt purposes set forth in IRC Section 501(c)(3) are charitable, religious, educational, scientific, literary, testing for public safety, fostering national or international amateur sports competition, and the prevention of cruelty to children or animals. The term charitable includes relief of the poor, the distressed, or the underprivileged; advancement of religion; advancement of education or science; erection or maintenance of public buildings, monuments, or works; lessening the burdens of government; lessening of neighborhood tensions; elimination of prejudice and discrimination; defense of human and civil rights secured by law; and combating community deterioration and juvenile delinquency. Several of these purposes have separate tests that must be met to qualify. Visit the [Internal Revenue Service website](#) to see if your organization qualifies for exemption under one of these purposes.
 - b. Restrictions. To qualify for tax-exempt status, certain activities must be limited or prohibited. The restrictions may vary depending upon the type of exemption sought.
 - c. Dissolution Clause. In addition, for certain types of exempt entities including 501(c)(3) organizations, the corporation's assets must be permanently dedicated to appropriate tax-exempt purposes. This is typically demonstrated through a clause that requires the assets to go to another tax-exempt organization upon dissolution of the corporation. Failure to include these provisions will result in the application for tax-exemption being rejected.
2. Prepare the Bylaws. It is important to take a thoughtful approach when drafting or revising nonprofit bylaws. Boards and board committees sometimes spend months or even years trying to draft the perfect set of bylaws. Too often, they look to bylaws of other nonprofit organizations or samples gleaned from the Internet with no regard to whether the bylaws match the structure and style of the organization or comply with state and federal law. Unfortunately, this approach usually leads to confusion, delay, and conflict on the board. The better practice is to work with a knowledgeable attorney from the beginning, starting with a compliant template, and tailoring it to the needs of your organization. The bylaws should include, at a minimum, the following:
- a. Governance Structure. It is important to understand whether the organization is board driven or member driven. If the corporation is board driven, there are typically no members or the members have very limited rights. If the organization is member driven, the members are typically voting members who have the power to elect and remove the board of directors. Voting members have statutory rights under state law; therefore, it is important to clarify the right of members to avoid inadvertently creating a voting membership class and vesting ultimate control in the members when that is not your intention.
 - b. Control Provisions. Generally, no one owns a nonprofit corporation; however, there is always control. Once it is determined whether ultimate control will be vested in the board

or one or more members, there are some additional considerations that impact who will exercise influence over the organization. In many states, a nonprofit corporation can have a board or members that are appointed by third parties or whose positions are tied to an office or position that they hold. Reserved powers and super-majority votes can also be used to balance power among competing interest groups in a nonprofit corporation. For example, reserved powers require approval of one or more members, delegates, or stakeholders to take certain actions such as removing a director, appointing a replacement, amending governing documents, etc. Super-majority votes require directors holding more than a majority of the votes (e.g., 66%) to agree before certain actions can be taken.

- c. Director's Terms. It is important to clarify directors' terms of office. Typically, director's terms are successive or staggered. Successive terms are terms that all end at the same time. Staggered terms mean that directors are divided into groups whose terms are up at different times. The benefit of staggered terms is that they can promote continuity on the board by ensuring there is always a group of experienced directors on the board while the new directors are getting up to speed.
- d. Ex-Officio Directors. The bylaws may also specify ex-officio directors. Ex-officio directors are not subject to terms. Instead, the board seat is tied to a particular office. For example, the President may be an ex-officio member of the board. If so, whoever holds the office of President will automatically be a member of the board. If the President steps down and a new President is appointed, the new President would automatically become a member of the board because the board seat is tied to the office rather than the individual. Ex-officio members can be voting or non-voting. The bylaws should also address how directors are removed and replaced.
- e. Officers. The bylaws should clarify who the officers of the organization are, how they are elected or appointed, their terms, their duties and how they are removed and replaced. Arizona law does not require any particular offices but the most common offices are a President, Secretary and Treasurer. It is also important to state whether all officers must also be directors or whether staff members can serve as officers.
- f. Voting Procedures. This section should include key information such as the number of directors who must participate to hold a valid a meeting (i.e., a quorum), the number of votes required to be an act of the corporation, and should restate many of the statutory requirements such as notice requirements for ease of reference. Note that a corporation with voting members will need to spell out the voting rules applicable to members as well as directors.
- g. Committees. Rather than outline the rules for ad hoc committees, it is generally preferable to streamline the bylaws and reduce the need to pass amendments by simply stating how committees may be created and abolished. It is also important to state in the bylaws what authority may be delegated to committees and what actions must be taken by the full board. Committees can then be created and abolished by board resolution

rather than a cumbersome bylaw amendment. Many organizations like to provide a provision authorizing advisory committees that can be used to involve additional members of the community in a less formal way or to groom future leaders of the organization.

- h. Conflicts of Interest. Modern bylaws often include provisions stating how the corporation will manage transactions where there is a conflict of interest between the corporation and an insider. Improperly managed conflicts of interest are one of the quickest routes to IRS penalties and accusations of breaches of fiduciary duty. Accordingly, it makes sense to provide a procedure for handling conflicts in the bylaws for easy reference. Alternatively, the bylaws can require the corporation to adopt a separate conflict of interest policy.
- i. Amendments. The bylaws should clarify how they can be amended. They may be amended by the board, by the membership, or with the approval of a third party or some combination of these. Some boards choose to require a super-majority vote (e.g., 66%) to pass bylaw amendments to ensure a high degree of consensus before changes can be made.

Too often, nonprofits include provisions in their bylaws that are old-fashioned, unnecessary, redundant, or that complicate rather than streamline governance. Examples include the following:

- a. Information that Will Change Frequently. The bylaws should reflect the fundamental rules governing the organization that are not likely to change frequently. Staff job descriptions, detailed committee charters, rules for conducting the annual meeting, guidelines for fundraisers, etc. are better suited for board resolutions or the nonprofit's policies and procedures manual. In this manner, the board can avoid constantly amending the bylaws when a simple resolution will suffice.
- b. Processes and Procedures that are Ignored in Practice. Many ambitious boards impose numerous procedures with strict deadlines in the bylaws. Examples include specific deadlines for meetings, notices, reports, committee action, etc. If the board is not going to carefully adhere to these procedures and deadlines, it is far better to omit them. If the processes and procedures called for in the bylaws are not followed, those who disagree with board action will always find a way to challenge the board's decisions based on a technicality.
- c. Detailed Provisions Outlining the Nonprofit's Purposes and Activities. I see a lot of bylaws with extensive purpose clauses that become obsolete over time. When this happens, the bylaws have to be amended to reflect the organization's current activities. Rather than risk a conflict between the articles of incorporation, the bylaws and the organization's actual activities, stick to a broad charitable purpose clause that will permit the organization's activities to evolve over time.

- d. Ambiguous Member Provisions. Voting members of a nonprofit corporation are analogous to shareholders. While they do not have ownership rights, they usually have rights to select board members and approve key decisions. Many state nonprofit corporation statutes will grant “members” certain rights unless the bylaws expressly limit their powers. Some state statutes even grant rights to voting members that cannot be overridden by the articles of incorporation and bylaws. Once voting members have been created, their consent is usually required to reduce their rights so references to “members” should be made with extreme care.
- e. References to Robert’s Rules of Order. It’s common for nonprofits to incorporate Robert’s Rules by reference into their governing documents. Robert’s Rules can serve as a useful guideline for large boards; however, many people do not realize that Robert’s Rules of Order require much, much more than just a motion and a second; it is a comprehensive body of work. Incorporating Roberts Rules in the bylaws permits challenges to board action on a technicality. When a dispute develops, the failure of a board that has incorporated Robert’s Rules into their bylaws to fully follow them leaves their actions open to challenge. The better practice is to reference Robert’s Rules as a guideline rather than a requirement or better still, leave it out all together.
- f. Complicated Due Process or “Cause” Provisions for Removing Directors, Officers or Members. If a majority of the board of directors have determined that an individual needs to be removed, due process and “cause” provisions only draw out the process and create legal hurdles the individual can use against the nonprofit. This may make sense for an organization where expulsion could lead to economic consequences such as a professional society. Otherwise, it is in the nonprofit’s best interest to have the ability to remove problematic individuals without due process and without cause.
- g. Statements Requiring the Nonprofit to Comply with the Law. This one always makes me laugh. So, without the provision, the board would feel empowered to break the law? It’s redundant and increases the amount of unnecessary verbiage. Leave it out.

Once the key terms related to a nonprofit corporation’s governance structure, control provisions, director’s terms, officers, and voting procedures and clearly articulated and the redundant, overly complex, and frequently changing items are removed, the board should be left with a workable document to guide its deliberations.

3. Prepare Governance Policies. We recommend that newly formed charities adopt certain key governance policies. Policies are helpful to attach the organization’s application for tax-exempt status. Arizona law requires certain Arizona nonprofits to have a Conflict of Interest Policy. Whistleblower and Document Retention and Destruction Policies help the corporation comply with Sarbanes Oxley’s criminal provisions. Other governance policies that are typically considered at this stage include Gift Acceptance, Compensation, Fundraising, Travel and Expense Reimbursement, Form 990 Review, confidentiality, signature authority and Joint Venture policies. Some policies are required by state or federal law and others may be recommended or desirable based on the nature of the charitable work and goals of the

organization. Because the state legislature regularly updates the applicable statutes during each legislative session and because your policies should be tailored to meet your organization's needs, you should consult with an experienced attorney to ensure that any policies related to the operation of the nonprofit comply with the current laws and that the policies are appropriate for your intended program.

4. Hold Organizational Meeting. At the organizational meeting, the incorporators will appoint the rest of the board if they have not already done so in the articles. They will also approve the corporation's articles and bylaws, adopt governance policies, pass a banking resolution authorizing the opening of a bank account, and authorize the hiring of staff.

5. Obtain Tax Identification Number. In order to open bank accounts, the corporation will need to obtain a tax identification number from the IRS. A Federal Employer Identification Number ("EIN") is a taxpayer number issued by the Internal Revenue Service. It is similar to a social security number for an individual but is used for a corporation or other business entity. Every legal entity must have an EIN. An organization seeking recognition of income tax exemption must have an EIN before submitting its application to the IRS. The EIN can be applied for by filing [Application for Employer Identification Number - Form SS- 4](#) online. Once you have the EIN, the organization is recognized as a legal entity by the Internal Revenue Service.

In Arizona, the time required to accomplish these steps depends on how complex the governance structure is, how quickly the founders can make the necessary decisions, and how quickly the Arizona Corporation Commission can process the articles. If the articles are filed on an expedited basis, a new Arizona nonprofit corporation can usually be formed in a few days. Once the entity is formed, the next step is to apply for tax-exempt status.

Part III: Applying for Tax-Exempt Status

Forming a nonprofit corporation is not the same as being tax-exempt. To obtain 501(c)(3) status, newly formed entities must apply to the IRS for a formal determination of exemption. Entities seeking 501(c)(3) status apply by filing Form 1023.

Newly formed organizations applying for exemption face a chicken and egg dilemma. Form 1023 requests considerable detail regarding the charity's planned programs and activities. The attitude of the IRS is that requiring applicants to articulate detailed plans is a small price to pay for the significant tax benefits associated with 501(c)(3) status.

1. Narrative Statement. Newly formed organizations often struggle to articulate their plans with the level of specificity the IRS demands. We generally try to provide at least a paragraph or two describing the who, what, when, where and how of each of the entity's separately identifiable programs or activities. Narrative statements that are very brief tend to elicit additional questions from the IRS. Narrative statements that go on for pages create an impression of trying too hard. We generally try to provide a 1-2 page narrative description.

2. Language Matters. Many applicants unknowingly use language that has a specific meaning in tax-exempt organizations jargon. This can confuse the IRS and generate long lists of questions that may not apply, but nevertheless must be responded to. For example, there are strict rules that govern whether scientific research is “in the public interest” or “commercial.” Statements that the organization conducts “research” are likely to trigger a list of questions pertaining to scientific research. The terms “advocacy,” “partnership,” “political,” and “publishing” can cause similar confusion.
3. Ancillary Documents. Often, the IRS will ask applicants to provide various contracts, grant applications and agreements, scholarship applications and guidelines, cost sharing agreements, and other evidence supporting the applicant’s plans. We have found that preparing and submitting drafts of the documents the planned activities call for with the application for exemption can streamline the process significantly.
4. Timing. The IRS has a process to screen applications. Applications that raise no issues with the IRS screener are processed within a few weeks to a few months. If the IRS screener has any issues or concerns, the application is assigned to a specialist for review. Lately, it has been taking over a year for the file to be assigned to a specialist. Once a file has been assigned, we usually receive follow-up questions within a few months. The time required to resolve follow-up questions depends upon the complexity of the issues and the experience and training of the specialist.
5. Expedited Processing. It is possible to request expedited processing of the application in cases where the applicant has been offered a grant that will lapse unless the entity provide the funder with a favorable determination letter by a specific date. Evidence of the grant will have to be submitted with the expedite request.
6. Interim Fundraising. Until the new charity receives its determination letter, it should disclose to potential donors that an application for 501(c)(3) status is pending. If the application is filed within 27 months of the date of incorporation and is ultimately approved, the entity’s 501(c)(3) status will be retroactive to the date of incorporation. Donors who claim a charitable deduction before the IRS issues its determination letter assume the risk that the organizations application will not be approved. Many nonprofits work with a [fiscal sponsor](#) during its start-up period to ensure their donors that their contributions will be deductible.
7. User Fees. The IRS charges user fees to file an application for exemption. Organizations whose gross receipts average less than \$10,000 per year pay \$400. All others pay \$850.

Ellis M. Carter, J.D., LL.M is the founder of Carter Law Group, P.C., a law firm devoted to advising nonprofit, tax-exempt and mission based businesses with respect to corporate, tax and regulatory matters. Ellis has been representing nonprofits for over 18 years and has been selected by her peers for inclusion in Best Lawyers in America for Non-profit and Charity law 2007-2014, has been rated 10/10 Superb by Avvo and as "AV Preeminent" (the highest rating available) by Martindale Hubble. In addition, Best Lawyers in America has designated Carter Law Group as one of only two First Tier firms for nonprofit law in Phoenix for the last three



years. Ellis is also the publisher of www.charitylawyerblog.com, named one of the top 50 blogs for nonprofits of 2012. Carter Law Group offers both full and unbundled services to nonprofits, often for an easy to budget flat fee.