

A GUIDE TO
STARTING A NONPROFIT
IN TENNESSEE





A joint project of the United Way's Venture Forward and the Community Foundation of Greater Chattanooga.

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A Guide to Starting a Nonprofit in Tennessee is a joint project of the United Way's Venture Forward (previously the Center for Nonprofits) and the Community Foundation of Greater Chattanooga. Venture Forward empowers and strengthens impact in the social sector through community building, professional development, advocacy, and innovation. The Community Foundation of Greater Chattanooga encourages giving and inspires action to improve lives in the Chattanooga area.

This guide is intended to help you decide whether developing a new nonprofit organization will be the most effective way to do your good work. If you need help deciding whether the nonprofit form is right for you or if you need assistance navigating the start-up process, please contact the Venture Forward.



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Disclaimer

The information contained in this guide is for informational purposes only and should not be considered legal advice and does not indicate a funding interest. If you have questions that pertain to your specific organization, you should seek the advice of a knowledgeable, qualified attorney. Venture Forward maintains a referral list of local attorneys, accountants and other service providers who have indicated that they have experience working with nonprofit organizations and are qualified to do so.

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SECTION 1 Overview of the Nonprofit Sector and Nonprofit Organizations

The Nonprofit Sector Nationally and in the Chattanooga Region.

According to the Urban Institute's Nonprofit Almanac, the nonprofit sector has been growing for many years, in terms of size and financial impact. Recently, over the course of a decade, the total number of nonprofits in the U.S. increased 25 percent; from 1.25 million to 1.57 million. Growth in the nonprofit sector has often outstripped that of both the business and government sectors. In addition, the nonprofit sector contributes 5.4% of the nation's gross domestic product, or around \$905.9 billion. Nonprofits also employ so many people that they account for 9% of the country's wages and more than 10% of jobs.

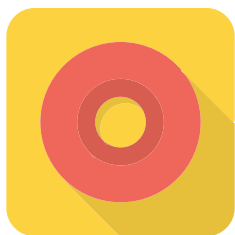
Chattanooga is home to a robust and diverse nonprofit sector. Over the years, the nonprofits here have changed the shape of the community, from the Tennessee Aquarium to United Way to the River City Company and hundreds of others, nonprofits have had an enormous impact on this community. According to research conducted by Venture Forward, and based on the Internal Revenue Service's Publication 78, Hamilton County has around 1,000 nonprofits or one nonprofit for every 360 people.

Questions to Consider Before Deciding to Become a Nonprofit.

Before we begin discussing what a nonprofit is and what they are required to do, we must consider whether forming a nonprofit is the right decision for you and your new organization. Initially, you will want to understand the need for the work you wish to do in the community. For example, what evidence is there that the community needs this kind of program? Do you know what programs are already working on this issue or problem? Is another charity doing similar or identical work? Could your effort be started under an existing charity or program? Are there national models for this work that you might gain information and support from? Often times, those who wish to start a nonprofit suspect that there may be a need, but have not yet done the research to fully understand the issue in the community. This research is a very important first step to creating an organization that is stable and sustainable for the long-term.

Many very successful community projects are completed without creating a new nonprofit, such as the 21st Century Waterfront Project in downtown Chattanooga. Ask yourself whether creating an entirely new entity and complying with the regulations and requirements mentioned in this guide is necessary. For example, you may be able to serve the cause you are interested in through another means, as in the following models.

SECTION 1 Overview of the Nonprofit Sector and Nonprofit Organizations



DONUT MODEL

Operating without a formal organization

- Do you need an entity at all?
- Could you complete the project with no formal organization?
- Could you develop a for-profit business?
- Could you create a social enterprise project in which a portion of a for-profit's assets are set aside for charitable endeavors?



UMBRELLA MODEL

Operating under the umbrella of another organization

- Could you create a fund housed at a community foundation or through another fiscal agent or charity?
- Could a new program be created at an existing nonprofit?
- Is it possible to develop a new branch of an existing organization?
- Could your group collaborate with existing organizations?



NEW 501(C)(3) MODEL

Operating a separate legal entity

- Should you complete both the state and federal process to create a new 501(c)(3) organization?
- Do you have the funds, time and expertise necessary to complete this process?
- Do you have the funds, time and expertise to comply with the ongoing reporting and regulation requirements?

Keep in mind that the selection of one of the first two models does not preclude the later adoption of the third model. These options can often allow the good work you are interested in to come to fruition. The task of creating and sustaining a nonprofit is a difficult one. Considering other options is a conversation you and your stakeholders will want to have before this decision is made. Below is a chart that considers some of the pros and cons associated with starting and running your own nonprofit organization.

PROS	CONS
Exempt from paying federal, corporate income taxes	Wait time - it can take 18 months for exempt status
Possibly exempt from some other federal taxes	Initial and annual report filing fees
Exempt from some state taxes, with application	State filing and disclosure requirements
Exempt from some property taxes, with application	Federal filing and disclosure requirements
Donors may receive a tax deduction	Limits on lobbying for legislation
Qualify to apply for grants	Prohibition on involvement in political campaigns
Reduced mailing rate through bulk permit	Assets may not be used to benefit private individuals
Corporate status offers limits on liability	Fundraising is competitive and often difficult
	Transparency - nonprofit information is public

SECTION 1 Overview of the Nonprofit Sector and Nonprofit Organizations

What is a Nonprofit?

People often have a hard time defining the term “nonprofit.” A common misperception is that nonprofit means that an organization that can’t make money. While a profit motive can’t be the primary purpose of a nonprofit organization, many nonprofits make large profits in a given year. The term “nonprofit” has to do with where profits can be directed. A good starting definition is:

An entity permitted by the government that exists for public or member benefit and does not distribute profits to individuals.

There are dozens of kinds of nonprofits including educational organizations, chambers of commerce, federal credit unions, social clubs and trade associations. In fact, the Internal Revenue Service (the IRS) allows 29 different types of nonprofit organizations. What do they all have in common? Each of these organizations is “tax exempt” at the federal level. This means that these organizations do not have to pay federal corporate income tax, along with some other kinds of federal taxes.

This publication is primarily concerned with a certain type of nonprofit – organizations that want to obtain section 501(c)(3) status from the federal government. Why do so many groups seek 501(c)(3) status? These organizations are unique in that 1) they are exempt from paying federal income tax and 2) donations made to them by individuals, businesses and others may be tax deductible. This tax deduction benefit is unique to 501(c)(3) organizations... with very few exceptions.

SECTION 1 Overview of the Nonprofit Sector and Nonprofit Organizations



What Kind of Organizations Can Become 501(c)(3)s?

The IRS provides a specific list of the kinds of organizations that can seek 501(c)(3) tax exemption. Permitted organizations must be organized and operated exclusively for one of the following purposes:

Religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals.

The term “charitable” covers a broad range of missions from the arts to the environment to health and human services. Because there are so many kinds of nonprofit organizations, we will use the term “charity” to refer to those that seek or are exempt under section 501(c)(3).

What Other Kinds of Requirements Do Charities Have to Meet?

Charities in this country operate under a complex and ever-expanding regulatory system. Fortunately, the IRS provides very specific rules and regulations for organizations that seek to become tax exempt. Charities must have one of the purposes listed above, and:

1. **Entity:** Only certain kinds of organizations can become charities. Typically, nonprofits are corporations, but there are some exceptions.
2. **Non-Distribution Constraint:** Charities may not distribute their net earnings to or for the benefit of individual people. This means that charities cannot share their profits with board members, founders and others associated with their organization. Charities are, however, permitted to pay reasonable compensation to their employees.
3. **Limited Lobbying:** There are limits on the amount of lobbying a charity can do.
4. **No Participation in Political Campaigns:** Charities may not get involved in an individual’s campaign for political, elected office.

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Are There Any Other Requirements?

Along with the basic requirements laid out above, the IRS has also developed tests to ensure that charities actually serve the public good. In addition to these requirements, developing your own nonprofit requires that you follow the technical process described below under Section II.



ORGANIZATIONAL
TEST

The IRS will consider whether a charity has been “organized” for a charitable purpose. The IRS will look at the charity’s organizing documents such as their mission, charter and bylaws to make this decision.



OPERATIONAL
TEST

The IRS will consider whether a charity is “operated” for a charitable purpose. Here, regardless of what the charity’s forming documents say, the IRS wants to make sure that the organization actually operates its business for a charitable purpose as well.



ASSETS MUST RE-
MAIN CHARITABLE
FOREVER

The assets of a nonprofit organization must remain charitable forever, even if the organization closes its doors. This means that any assets given or donated to a nonprofit cannot later be taken out and used for a for-profit purpose.



PUBLIC CHARITY
TEST

The IRS will also ask where a charity’s money comes from. A charity must either be “publically supported” (meaning a significant percentage, 33.3% or more, of their money comes from the public, as defined by IRS regulations) or it must be a “supporting organization” (meaning that the funds of the organization are used to support a 501(c)(3) – for example, the Memorial Healthcare System Foundation supports Memorial Hospital and its affiliates, not other outside charitable organizations). Note that the public charity test is an ongoing requirement. The penalty for not reaching this level of public support could be a reclassification as a private foundation. This reclassification would likely hurt a nonprofit’s fundraising prospects among certain funders.

SECTION 2 Technical Process to Form a 501(c)(3)

If you decide that becoming a nonprofit organization is right for your work, you will need to learn a lot about how to set up a nonprofit and steward it through the regulatory process each year. This section serves as a basic outline for the technical process an organization must follow to become tax exempt at both the state and federal level.

Initial Steps to Create a Nonprofit Organization

Before you begin the technical process of creating a nonprofit organization, consider developing 1) a group of interested people who can serve as those who will incorporate the organization and, possibly, initial board members; 2) vision, mission and values statements; and 3) a needs assessment, indicating the need for your program in your community or the reasons why your program will improve your community.

In order to create a nonprofit organization, you will need to enlist the help of a group of passionate, interested volunteers from the outset. Nonprofits need volunteers with diverse skills, backgrounds, experience and interests to ensure good governance and management for their organization. For example, if your organization owns significant property or manages a number of facilities, you might consider including volunteers with building maintenance, facilities planning and real estate experience. In terms of diversity, you might consider professions, age, gender, race, ethnicity, resources, community connections and previous board experience. Also important are candidates' personality types, leadership styles and interpersonal skills. Venture Forward can offer a "Board Composition Grid" and several other tools to help nonprofits determine the various skills, talents and diversity they might wish to include on their board.

What is a Board?

A strong and engaged board of directors may be the biggest factor in the long-term success of a nonprofit organization. The board of directors, is the governing body of the charity. This means that it is responsible for governing and providing oversight for the organization as a whole. The board has a number of responsibilities, including:

- Selecting, hiring and evaluating the chief executive officer
- Determining mission, vision, programs and services
- Stewarding organizational planning
- Ensuring legal and ethical compliance
- Maintaining financial accountability and organizational transparency
- Identifying, nominating and recruiting new board members
- Ensuring succession planning
- Program and organizational evaluation
- Promoting the organization and protecting its reputation

Boards are responsible for ensuring that their operations are well-managed and that continuity for governance can be passed to the next generation of board members each year. Offering a robust board orientation, using board member job descriptions and having a solid committee structure in place will assist a board in being as effective as possible. In addition, thoughtful board officers with consideration to training those who succeed them will also be beneficial.

SECTION 2 Technical Process to Form a 501(c)(3)

What are some of the skills your board will need to effectively govern your organization? Among others, your board will need experience and expertise in programs, governance nominating, board education, committees and development, fundraising, planning, marketing, public relations and communications, finance and accounting, investments, legal, political, an understanding of the larger community, leadership, personnel and evaluation.

Note that all boards are different. Many nonprofit organizations have no staff, at least in the beginning. In this case, the board may do much of the work that staff would do in a larger organization. While “working boards” are common and can be very useful, keep in mind that board members still owe specific legal duties to their organizations and are still responsible for governing the organization.

Mission, Vision and Values Statement

Charities must not only develop a charitable purpose as they begin operation, but they must also define their mission, vision and values in writing so that they can be shared with others. These statements tell both internal and external constituents what is important to the organization.

- Vision: What does your organization want for the future? What does success look like to your organization?
- Mission: How will your organization make that vision a reality? What will you do to reach your vision?
- Values Statement: Provide direction to the staff and board for what truly matters to the organization. What does the organization care about? What defines the organization and the people associated with it?

Community Needs Assessment

Charities must have specific knowledge of the needs of their community and how they plan to address them. Can those associated with your charity show a need in the community? Can you show a thorough understanding of that need? What other solutions have been tried? What other organizations are serving this need? Many charities conduct a needs assessment before beginning operations and then periodically once they are in operation. This way, services can be coordinated with other agencies and partners, thereby, avoiding a duplication of services.

The Start Up Process – The Technical Side

Before we consider the technical side of the nonprofit start up process, be aware that this is not a linear process. Many of these tasks will need to be accomplished simultaneously; some have to occur before others. Know also that this process rarely runs smoothly or quickly. Changes may need to be made as you go along.

SECTION 2 Technical Process to Form a 501(c)(3)

STEPS TO STARTING A CHARITY IN TENNESSEE

As you consider this process, keep in mind that the entire process of developing a nonprofit organization often takes a year to 18 months, possibly more.

- Determine Original Incorporators: In Tennessee, each charity must have “original incorporators” who will serve to start up the organization as a corporation. Often times, the founders and those who will become early board members will serve as original incorporators.
- Select a Name for your Organization: Each corporation in Tennessee must have a unique name that no other organization has used. The Secretary of State’s Office offers a free online tool to check business name availability. <https://tnbear.tn.gov/Ecommerce/NameAvailability.aspx>.
- Develop Organizational Bylaws: Corporations in Tennessee are required to have bylaws, by which their board of directors will govern the organization. Bylaws are really an operations manual for the board. Bylaws often contain information on how large the board will be, what officers it will have and what their roles will be, how voting will take place, how conflicts of interest will be handled and the like. Bylaws are not a public document, but will be filed with the state and possibly other regulating authorities.
- Incorporate with the Tennessee Secretary of State’s Office: Using a form ss-4418, the Charter Nonprofit Corporation form, the original incorporators must file to become a nonprofit corporation at the state level. The Charter form, also known as Articles of Incorporation, is short and relatively simple. It asks for basic information about your organization, how to contact it, its mission and what will be done with assets if the organization dissolves. This form is available at: <https://sos.tn.gov/products/business-services/charter-domestic-nonprofit-ss-4418>.
- Register to Solicit Contributions: Your charity may also be required to register with the Secretary of State’s Division of Charitable Solicitations and Gaming if it plans to solicit contributions from the public. Generally, charities will need to register if they plan to raise money through donations, grants, fundraisers or other means.

There are several exceptions. For example, “organizations that do not intend to solicit and receive and do not actually raise or receive gross contributions from the public in excess of thirty thousand dollars (\$30,000) during a fiscal year” are exempt from registering. In addition, bona fide religious institutions, educational institutions, volunteer fire departments, rescue squads, local civil defense organizations, political parties, candidates for elected office, political action committees, hospitals, nursing homes and federally organized nonprofits do not have to register. If you believe that your organization is exempt from registering, you must file an exemption form with the state: https://sos.tn.gov/sites/default/files/forms/113755-Form_SS-6042_P4_fillable.pdf.

For more information on which organizations are required to register to solicit, you can visit the Division of Charitable Solicitations and Gaming’s website at: <https://sos.tn.gov/charitable>.

SECTION 2 Technical Process to Form a 501(c)(3)

- **Hold an Organizational Meeting:** After incorporation, an organizational meeting is required by the Tennessee Code (T.C.A. § 48-52-105). The organizational meeting is the forum for electing initial directors, appointing officers, adopting the final bylaws and beginning to conduct business. The organizational meeting is also when board meeting minutes and corporate records must begin being kept.
- **Develop a Plan and Budget:** Developing an organizational plan and budget may be among the most important tasks for ensuring that your organization is on good footing for success. Many charitable organizations develop plans for one, three, five years or longer to ensure that they know what work they will do to achieve their mission and how they will fund that work. Often, organizations develop budgets, a fundraising plan and a program plan. Organizations might also consider including timelines in their plans to make goal attainment a smoother process.
- **Apply for a Federal Employer Identification Number (EIN):** Charitable corporations are required to have an EIN, whether or not they have employees. The EIN is used to identify organizations on federal forms. Application for an EIN can only be made after the organization is formally incorporated at the state level. The process for obtaining an EIN is fairly simple and can be done online at <https://www.irs.gov/businesses/small-businesses-self-employed/apply-for-an-employer-identification-number-ein-online> or by filing a paper form SS-4 Form, which can be found here: <http://www.irs.gov/pub/irs-pdf/fss4.pdf>.
- **Develop Financial Systems:** Charitable organizations will need to develop strong financial systems to ensure stability and sustainability of operations. This process will involve opening bank accounts, hiring an accountant, bookkeeper and/or others with financial expertise and establishing financial controls and reporting procedures. Some organizations find it helpful to include an accountant or other financial expert on their board. When developing a financial controls process, organizations might consider developing a cash handling policy, an audit committee, a process for keeping records of property, a procedure for creating routine financial reports and a budget process and budget review process for the board.
- **File an IRS Form 1023:** The Form 1023 is the federal application for tax exempt status. Applying for tax exempt status and receiving a determination letter from the IRS, indicates that your organization is now tax exempt under section 501(c)(3) of the Internal Revenue Code. Organizations should submit their Form 1023 within 15 months of filing their charter at the state level. After 27 months, the IRS has indicated that it is unlikely that they will grant tax exempt status. In order to file your Form 1023, you will first need to have filed and received corporate status and a federal EIN number.

A form 1023 is a comprehensive, complicated 30-page document. Organizations may wish to seek legal or accounting advice in preparing the form, though this is not required. The Form 1023 can be downloaded here: <http://www.irs.gov/pub/irs-pdf/f1023.pdf>. The IRS has published a number of resources to help organizations with their Form 1023s, including comprehensive instructions, <http://www.irs.gov/pub/irs-pdf/i1023.pdf>, and Publication 557 Tax-Exempt Status for Your Organization, <http://www.irs.gov/publications/p557/index.html>.

SECTION 2 Technical Process to Form a 501(c)(3)

- **File for State and/or Local Tax Exemptions:** Seeking and receiving tax exempt status as the federal level does not mean that your organization is automatically tax exempt at the state level. In Tennessee, charitable organizations must apply separately for state sales tax exemption, as well as other exemptions such as property tax exemptions at the local level. Tennessee organizations can apply for Tennessee Sales and Use Tax exemption electronically, <https://www.tn.gov/content/dam/tn/revenue/documents/forms/sales/f1306901.pdf>. Information on property tax exemptions is also available electronically: <https://comptroller.tn.gov/boards/state-board-of-equalization/property-tax-exemptions.html>. In order to file for state tax exemptions, you will need to have your determination letter from the IRS, showing that you have been granted 501(c)(3) status.
- **Apply for a Nonprofit Mailing Permit:** The United States Postal Service allows nonprofit organizations to obtain a discounted mailing permit, but with a number of limitations. The permit applies only to bulk mail (of 200 pieces or more being sent at once), requires that mail be sorted by zip code and requires that each individual piece be exactly the same, with no personalization. The discount rate is approximately 40% lower than regular commercial mail. Organizations must also use the mailing permit at least every two years, or it could be revoked. Your organization must apply for discounted bulk mail rates: <https://pe.usps.com/businessmail101?ViewName=NonprofitPrices>. The USPS also offers a number of publications to assist nonprofits in this application process: <https://pe.usps.com/text/pub417/welcome.htm>.

Annual and Special Filings

In addition to the technical process discussed above to start up a charity, there are on-going requirements at both the state and federal level. Note that some localities may also have reporting requirements not covered by this material.

Tennessee Annual Filings

- **Annual Report with the Division of Business Services:** Nonprofit corporations in Tennessee must file an annual report with the Secretary of State's Division of Business Services each year. For more information on filing an annual report with the state for a nonprofit, you might consider reviewing Tennessee's Filing Guide for Nonprofit Corporations at: <https://sos.tn.gov/products/business-services/file-annual-report>.
- **Annual Registration with Division of Charitable Solicitations and Gaming:** All organizations that intend to solicit funds in Tennessee, whether directly or indirectly or from inside or outside the state, must register annually with the Division of Charitable Solicitations and Gaming. There are some exemptions and exceptions, as outlined above. Organizations may file electronically and forms are available online. For more information: <https://sos.tn.gov/charitable>.
- **Register Charitable Gaming Events:** If your organization plans to hold events that include charitable gaming events in Tennessee, your organization will need to apply with the Secretary of State's Division of Charitable Solicitations and Gaming. The application can be found here: <https://sos.tn.gov/charitable/gaming>. Tennessee only permits certain kinds of games of chance, including raffles, reverse raffles, cakewalks and cake wheels. All other games of chance are prohibited.

SECTION 2 Technical Process to Form a 501(c)(3)

A number of very specific rules regarding applications for these gaming events are also in place:

- Charities may only conduct one gaming event per year.
- Charities must provide IRS documentation indicating that they are federally tax exempt.
- The charity must have been in continuous existence in Tennessee for at least five years.
- There are geographical limitations on where events can be held, by county.
- Only two charities can operate an event each month at the same location.

In addition, organizations must generally apply a year in advance of when they wish to hold the event because these events are approved by the Legislature, which takes some time. A number of other rules concerning who can buy and sell game tickets and when charities must notify the state of changes or concerns are also in place. For more information on gaming events, please visit the Division's website: <https://sos.tn.gov/charitable/gaming>.

Federal Annual Filings

- Annual 990 Filing: Most nonprofit organizations are required to file some form of federal informational tax return each year. Nearly all 501(c)(3) organizations are required to file a federal Form 990 annually. The federal Form 990 and its instructions can be accessed electronically, here: <https://www.irs.gov/pub/irs-pdf/i990.pdf>. While it is not required to seek outside legal or accounting advice in advance of filing a Form 990, your organization might consider seeking such advice. For information on which type of return your organization should file: <https://www.irs.gov/charities-non-profits/annual-filing-and-forms>. The IRS has also developed an informational tool to provide more information on how to fill out a Form 990, <https://www.irs.gov/forms-pubs/about-form-990-ez>.

Once filed, IRS Form 990s are a matter of public record and are available for anyone to view at www.guidestar.org and several other websites. Often times, potential donors and volunteers use the Form 990 to better understand and evaluate nonprofit organizations and the work they do. Because the 990 is a public document, it should be considered a public relations tool. The information contained on the form should be reviewed from a marketing perspective before it is submitted.

SECTION 3 Legal Responsibilities of Nonprofit Board Members

LEGAL DUTIES OF BOARD MEMBERS

Board members, also called directors, of nonprofits are held to a higher standard than others because they are considered “fiduciaries.” A fiduciary, in this context, is someone with whom a beneficiary organization has a relationship of trust. Fiduciaries must act unselfishly and must provide their skills and knowledge to their organizations. Tennessee’s Office of the Attorney General has put together a guide on board member duties, and responsibilities: <https://sos.tn.gov/products/charitable-solicitations-and-gaming/2019-nonprofit-guidebook>. This useful resource is a good starting point for educating potential and current board members and staff on their role with a charitable organization.

Tennessee law requires that board members act in good faith with inherent fairness, diligence, attention, care and skill. In Tennessee, three main legal duties apply to those who serve as board members: the duties of care, loyalty and obedience. Each board member should be familiar with these duties, understand them and comply with them during their board service.



- **Duty of Loyalty:** Board members are expected to do no harm to their organizations and to put the organization before their personal interests. Board members must show their organizations undivided loyalty and always function with the best interests of the nonprofit in mind. Board members must also be cognizant of conflicts of interest and not seek personal benefit from the nonprofit on whose board they serve. Often, board members make annual disclosures of possible conflicts of interest so that the board, the organization and the board member can be vigilant regarding conflicts as the organization’s business is conducted.

If a conflict does arise, under Tennessee law the board member must 1) disclose the conflict 2) refrain from discussing the transaction or activity in which they have a conflict and 3) the remainder of the disinterested board must make the final decision on the transaction or activity. Training board members on how to remain loyal and follow the three step process for curing a conflict of interest is an important part of developing both a strong board of directors and a strong nonprofit organization.



- **Duty of Care:** Board members are also expected to take their job seriously, be prepared and be careful in fulfilling their duties. Boards must make reasonable decisions with complete information in good faith. Board members must be familiar with the organization’s activities and financial outlook, be prepared for board meetings, review documents they receive and ask for information they have not received, but feel they should. Board members must attend board and committee meetings. Board members must use their own good judgment, participate in planning and understand the activities, risks and programs the organization undertakes.



- **Duty of Obedience:** This duty, while less recognized and less commonly discussed, is also an important part of board service. The duty of obedience requires that the organization adhere to the charitable purposes stated in its Charter (or Articles of Incorporation) at all times. Board members must ensure that organizations do not stray from their intended charitable purposes and that all activities actively advance the mission the organization selected at the outset of operations.

SECTION 3 Legal Responsibilities of Nonprofit Board Members

In short, board members must be informed, engaged and dedicated to the organizations they serve. Compliance with these duties is very important in Tennessee. Board members who do not comply with these duties open themselves to personal liability for harm the organization suffers or causes another because they breached these duties. Educating, training and continuing to actively engage board members is something all nonprofit organizations should focus on.

Where to Find Board Members?

Nonprofit organizations often express difficulty in finding board members who are sufficiently engaged and interested. In the Chattanooga area, organizations often use the networking connections of their current board members to search for potential board members. While this is typically a useful method, it is limited in that current board members often know others who have similar skills and social backgrounds. You might consider those who have benefited from the services your organization provides and those who already show an interest in your work by volunteering in the area. In addition to networking, a number of local organizations and efforts may be able to help you find strong board members. For example, Venture Forward offers a number of programs that educate and develop potential board members. VF also has a “board bank” which connects possible board members to organizations that are looking for new leaders. Other organizations such as Leadership Chattanooga, Rotary Club and other civic organizations, Chattanooga Women’s Leadership Institute and the Community Foundation of Greater Chattanooga may all be able to help you connect with skilled individuals who are interested in board service. For more information on connecting with these groups, please contact the Venture Forward

SECTION 4 Basics of Governance of Nonprofit Organizations

What is Governance?

Governance is a term that is often difficult for nonprofit executives and board members to define. We will use the following working definition to organize our discussion of nonprofit governance.

Governance is the processes, policies, procedures and culture of an organization that encourages:

- Sound and strong leadership
- Appropriate distribution and use of authority
- Strategic planning and decision-making
- Appropriate oversight and controls

The governance of an organization is one of the many legal responsibilities of boards of directors. It includes a number of extremely important functions that should not be overlooked:

- Nominating new board members
- Orienting new board members
- Educating new and current board members
- Establishing and monitoring committee structure for effectiveness
- Evaluation of board performance
- Managing board meetings
- Developing a succession plan for board and committee leadership
- Reviewing, amending and updating bylaws
- Developing, implementing and then monitoring compliance with all policies and procedures such as conflicts of interest and confidentiality

Why Does Good Governance Matter?

Without good governance, a nonprofit organization may be unprepared for changes and crises, may not create plans for its future and may not understand the critical roles each member of the organization's team is responsible for. In short, without good governance, organizations face an uphill struggle to be successful in both the short- and long-term and they open themselves to unnecessary risks. A discussion of some key components of governance is below:

- **Committee Structure:** Often times, boards function best with a committee structure. Generally, the board is composed of individuals who have joined the organization to contribute specific skills and attributes. A number of working committees can also be put in place to divide the work of the board. Committees are often led by board members, but other members of the larger community may also contribute. These committees might include: executive, governance, audit, finance, fundraising, programs and the like. This structure helps ensure that work in each area of operations is completed and that those with useful skills in each area can focus appropriately on that work. This structure allows the full board more time to consider the big picture because the "detail work" is often done at the committee level.
- **Governance Committee:** Many nonprofit organizations use governance committees as a way to strengthen their organization and ensure that responsibilities are being met. Boards must do more than function as a program committee, they must govern the organization and provide legal and ethical oversight for all the work it does. The purpose of the governance committee is to manage the governance function as outlined above, including ensuring

SECTION 4 Basics of Governance of Nonprofit Organizations

that the board does its due diligence, developing a strong and stable overall board, developing a board committee structure, assessing the performance of the board and its members and educating the board about compliance. Another important, though less recognized, function of the governance committee is to educate board members. By developing a number of educational tools, such as board member job descriptions, a list of board member responsibilities and duties, a board orientation for new members and a board assessment tool, a governance committee ensures that board members understand their role and can fulfill it appropriately.

- Board Governance Responsibilities: The board has a number of governance responsibilities. The three listed below are among the most important.

1. Strategic Planning. The board of directors is responsible for ensuring that the organization has the tools in place to ensure long-term stability, sustainability and success. This begins with a strategic plan, which is really, in many ways, a business plan for a nonprofit organization. Boards must ensure that there is both a short and long-term strategic plan in place to guide the organization in advancing its mission. A strategic plan typically includes measurable goals and objectives, an analysis of the environment in which the nonprofit is operating and a definition of organizational success. For more on developing a strategic plan, contact Venture Forward or visit our website at www.ventureforwardnow.org.

2. Succession Planning. Another key governance responsibility for boards is to develop a succession plan for both the board and key staff leadership positions. Boards may want to develop a “pipeline” of future leaders by involving volunteers at the committee level and moving them up to the board level as appropriate. Often times, a board Nominating Committee can be useful in ensuring that potential board members are engaged with the board, so that the board has a full complement of skills it needs to be successful. The board should also be involved in succession at the staff leadership level, particularly with the CEO or Executive Director position. Developing internal leaders and cross-training staff can help ensure that nonprofits are prepared if a leader steps away unexpectedly.

3. Fundraising and Financial Oversight. Boards must also ensure that adequate fundraising occurs to create stability and sustainability for their organization. Comprehensive oversight of the financial well-being of the organization is also a key governance responsibility. While some board members are not comfortable raising money and providing financial oversight, this is a key responsibility of board members. Board members can get involved in a number of ways in raising money for their organizations, from helping prepare grant proposals to contributing contact information to donor mailing lists to inviting friends to events. Boards must provide financial oversight as well. Each board member must ensure that they understand financial reports, that they request further information if questions arise and that financial information is provided routinely to the board.

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Basic Board Responsibilities

Nonprofits and their board members are truly stewards of the dollars that the community has invested in their programs.

What does the board of an organization actually do?

Boards fulfill different roles than staff, though the two should work together harmoniously to advance the mission. In addition to the legal duties discussed above, boards are charged with a number of responsibilities that are strategic in nature and provide strong oversight for nonprofit organizations.

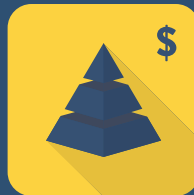
BASIC BOARD RESPONSIBILITIES



1. Determine the mission, purpose and strategic direction of the organization.



2. Determine and monitor organizational programs and services.



3. Ensure financial and organizational integrity, accountability and transparency.



4. Select, support and appraise the chief executive officer.



5. Ensure board efficiency, effectiveness and continuity.



6. Ensure adequate resources to further the mission.



7. Promote and support the organization to the community.

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Many nonprofits operate without staff. For those organizations, board members may function as staff and take on typical staff duties. If you find your organization in this situation, keep in mind that as growth occurs, changes in structure and the distribution of duties may be necessary. For more information on the responsibilities of board members, visit BoardSource: www.boardsource.org. BoardSource offers a number of valuable resources on developing a strong board, many of which are free.

PRINCIPLES OF GOVERNANCE FROM THE IRS

In recent years, the IRS has become more involved in monitoring the governance of nonprofit organizations by requesting more information on the federal Form 990, the annual “tax return” for nonprofits. While some have questioned the IRS’s authority in this arena, the information is nonetheless being requested and being collected annually. Specifically, the IRS will ask organizations whether they have the following governance policies in place. If an organization answers that they do not, this may or may not be a red flag for further IRS scrutiny of their return.

- **Conflict of Interest Policy:** prohibits officers and directors of nonprofits from receiving more favorable financial benefits than they would in an open market and prohibits an officer or director from enjoying priority over open market competitors without the approval of the board.
- **Whistleblower Policy:** protects an employee, volunteer or other person associated with a nonprofit from retaliation for exposing the wrong-doing of the organization or its employees.
- **Joint Venture Policy:** requires the board of a nonprofit organization to evaluate specific kinds of transactions under current tax law and focus on safeguarding the exempt status of the nonprofit with respect to those transactions.
- **Nondiscrimination Policy:** provides that nonprofit organizations will treat employees and job applicants fairly, and without regard to at least several federally-protected classes such as disability, race, creed, color, national origin or sex. States and localities may require that other classes be protected as well.
- **Donor Privacy Policy:** ensures that donors’ personal and donation information will be kept confidential and will not be shared with anyone outside the nonprofit organization, unless the donor approves.
- **Gift Acceptance Policy:** describes what types of gifts a nonprofit organization will and will not accept from donors and which staff or board members will make those decisions. The policy may also enumerate when the organization must seek outside legal counsel.
- **Document Retention and Destruction Policy:** identifies the types of paper documents and electronic files the nonprofit generates, lists how long the organization will retain them and requires monitoring progress with compliance in written form.
- **Review Process of Form 990:** allows board members, or a board subcommittee, adequate time to conduct a meaningful review of the nonprofit’s Form 990 before it is submitted to the IRS. This process should also allow for feedback and revisions based on input.
- **Executive Compensation Approval Process:** ensures that the board has approved reasonable, not excessive, compensation for the Executive Director or CEO of a nonprofit organization.
- **Meeting Minutes Documentation Procedure:** This process ensures that boards take minutes of their meetings while the meetings occur, not afterwards, and retain them safely for the long-term.

SECTION 5 Nonprofit Operations

Once you have completed the process outlined above, your organization will be up and running. To help ensure success and continuity, it may be useful at this point to consider the basics of nonprofit operations.

Administration: When developing your nonprofit organization, be sure to consider that it must operate as a business, not just as a charity. You will need financial systems, budgets, and insurance. You may need to obtain a business license, or other licensure, or health inspection, depending on the services you provide. You may need to hire employees; you may need to hire independent contractors; and you will certainly need to understand the difference between the two. You will probably want to use volunteers – they will need orientation, training, and monitoring. While it can be challenging to incorporate all of the necessary aspects of administering your nonprofit, there are resources in the community to help you manage this process. Often, Venture Forward offers training, services and referrals for administrative help. If Venture Forward does not have a resource you are looking for, its staff can usually make a connection and assist a nonprofit in finding the help it needs. More information is below in Section Six – Resources for Nonprofit Organizations.

Programs: Development and Evaluation - In recent years, nonprofit program development and evaluation has become far more focused on results. What difference does your organization make? Does the organization fulfill its mission? How do you know what your impact is? Those who invest in your organization will want to see specific, measurable results. Ask yourself whether you have the tracking and evaluation systems to demonstrate those outcomes, and if not, consider putting them in place.

Nonprofits have made great progress in designing programs with specific results, often called outputs and outcomes, in mind. As you develop your programs, be mindful of the concentration on showing impact and results. You might consider developing a tracking method, also known as a dashboard, that can simply and easily illustrate your results to constituents. Consider what kinds of data are available and can be tracked to show progress, allowing you to compare results from year to year. Program outputs and outcomes are often described this way: It's not how many worms the bird feeds its young, but how well the fledgling flies.

OUTPUTS:	Quantifiable, measurable activities and participation rates. Example: The number of students enrolled in an afterschool reading program.
OUTCOMES:	Measurable results that an organization can directly influence through its programs and activities. Example: The improvement in reading scores of students who participated in your after school reading program over the course of a school year.

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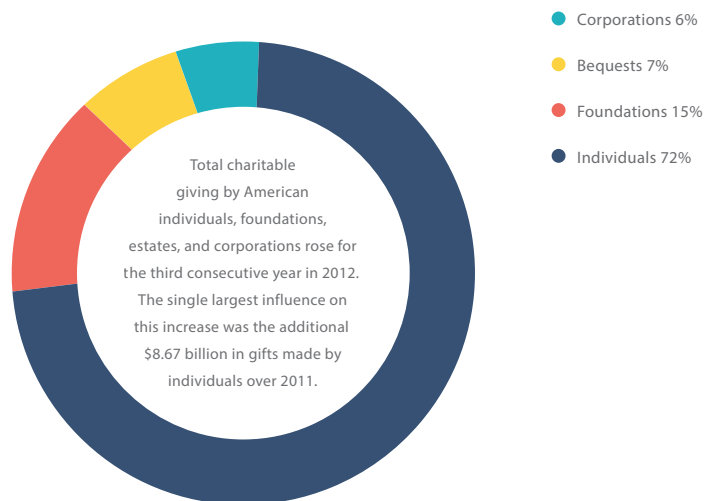
Another important part of program development is ensuring that all new endeavors align with and advance your organization's mission. As mentioned above, one of the legal obligations of board members is to focus on mission and be obedient to that mission. When considering developing new programs, eliminating old ones, or changing offerings, a clear focus on mission, vision and values is invaluable.

Fundraising: One of the most common reasons given for becoming a nonprofit is seeking grants. While grants are a valuable tool to achieving a charitable mission, there are certainly a number of other ways to raise the money your organization will need to do its work. In fact, a diversified fundraising program is an extremely important part of the success of most nonprofits. The question then becomes, how do you develop a diversified fundraising program?

According to the National Center for Charitable Statistics, public charities reported more than \$2.04 trillion in total revenues and nearly \$1.93 trillion in total expenses in 2016. (Source: Nonprofit Sector in Brief 2019 - <https://nccs.urban.org/publication/nonprofit-sector-brief-2019#the-nonprofit-sector-in-brief-2019>).

In the United States, more than \$300 billion is donated to charity each year. Gifts from individuals total nearly 80% of all the funds given, while businesses contribute around 6% and foundations about 15%. This is often surprising to people entering the sector – they often think that businesses and foundations provide the bulk of funding to nonprofits. Each year, GivingUSA publishes a full, national report on giving. A summary of highlights from the full report is available to download: <https://store.givingusa.org>. Other more in-depth reports are also available to download for a modest fee.

Source: GivingUSA 2012



TOTAL 2012 CONTRIBUTIONS: \$316.23 BILLION
2012 contributions by source (by percentage of the total)

SECTION 5 Nonprofit Operations

A well-diversified fundraising program includes funding sources from all of the vehicles discussed above. From individuals to foundations to businesses to earned income and government contracts, identifying diverse sources of income builds long-term sustainability for a nonprofit organization. The realities of the fundraising environment are sobering: competition is stiff, government funding is on the decline and developing more sophisticated funding sources, like planned giving – contributions to nonprofits through wills, estates and other more complicated methods – is often a daunting task. Keep in mind that most foundations have policies against providing grants for general operating expenses. A thoughtful and realistic development plan is key to nonprofit success.

Financial and Management Systems: The development of financial systems is often lacking in nonprofit organizations. This may happen for a number of reasons, but often nonprofit organizations and boards lack financial experience and expertise. A number of financial myths also surround the sector: nonprofits can't make a profit, they are required to have balanced budgets and they can't have surpluses... none of this is true. Nonprofits, at their core, are businesses and need to be operated with strong financial controls, policies and oversight.

Nonprofits need financial accounting systems – a chart of accounts, a general ledger, journals, checkbooks and an accounting procedures manual. They need to select an accounting method (i.e. cash or accrual). They need an organizational budget, program budgets and income budgets. They need to create and share regular financial reports with their board and other constituents, including balance sheets, income statements, cash flow statements and any other reports that help the board provide appropriate fiscal oversight. A collection of financial policies is also useful, such as a cash handling policy and a property inventory policy.

Nonprofits also need to have dual controls in place. Dual controls means that control over fiscal tasks is distributed to more than one person, so that there are sufficient checks and balances. For example, checks exceeding a certain level, the actual level will vary, should require two signatures. Another example: the person who writes and signs the checks is not the same person who opens and reconciles the bank statements. These kinds of controls help avoid costly fiscal mistakes that can damage both the finances and the reputation of a nonprofit.

In addition, most experts now agree that a standing audit committee may be a requirement for nonprofit organizations under the Sarbanes-Oxley Act of 2002. The audit committee works closely with staff to prepare the organization for an independent audit, which is typically conducted by an outside CPA with no connections to the organization. An independent audit is a gauge of the financial health and stability of an organization and alerts organizations to problems or concerns with their current system. The audit committee then works to correct problems. The audit committee should also evaluate the auditor from time to time to ensure the audit is as useful as it can be. In Tennessee, nonprofit organizations with more than \$500,000 annually in gross revenue must submit an independent audit with their annual reports to the state. For more information on audits, see Tennessee Code Annotated 48-101-506 -<https://sos.tn.gov/sites/default/files/forms/Charitable%20Solicitations%20Act%20effective%207-1-15.pdf>

SECTION 5 Nonprofit Operations

A myriad of financial, human resources and management issues come up routinely in a nonprofit just like they do in a for profit setting: payroll taxes, unemployment insurance, compliance with laws like the Family and Medical Leave Act and the Fair Labor Standards Act. Expertise related to employment benefits such as retirement plans, called 403(b)s in the nonprofit world, health insurance and flexible spending accounts is necessary. Keep in mind as well that nonprofits are not exempt from paying payroll taxes and many other kinds of business taxes. Understanding insurance coverage needs, especially general liability insurance and directors and officers insurance, and ensuring those policies are in place is an important part of a nonprofit's financial and business systems as well. Nonprofits may need to engage experts in these areas to ensure systems are in place for compliance and stability, before a crisis happens.

Administrative Systems: While they serve a charitable purpose, nonprofits are businesses like any other and need to be run as such. Often, dedicated people who wish to start a nonprofit do not have a full understanding of the investments of time, expense and other resources required to create a business from the ground up. What is required to get a charitable mission off the ground as a business? Accounting, programs and fundraising software, websites, communications systems such as telephones, email, voicemail, fax and mail, computer and office equipment hardware and much, much more. For those organizations wishing to employ staff or use volunteers, a whole world of human resources issues needs to be considered. These systems can add up to major expense and need to receive careful consideration from the earliest stages of organizational development.

SECTION 6 Resources for Nonprofit Organizations

Below is a collection of resources designed to help nonprofit start-ups as they begin operations. If your organization needs further resources, training or consulting, please contact Venture Forward.

Tennessee State Government

- Nonprofit Filing Guide: <https://sos.tn.gov/business-services/non-profit-corporations>
- Nonprofit Guidebook: <https://sos.tn.gov/products/charitable-solicitations-and-gaming/2019-nonprofit-guidebook>
- Solicitations and registration information: <https://sos.tn.gov/charitable>

Internal Revenue Service

- Tax Exemption Guide: <http://www.irs.gov/pub/irs-pdf/p557.pdf>
- Form 1023 and Instructions: <https://www.irs.gov/charities-non-profits/application-for-recognition-of-exemption>
- Form 990: <http://www.irs.gov/pub/irs-pdf/f990.pdf>
- Form 990 Instructions: <http://www.irs.gov/pub/irs-pdf/i990.pdf>

Financial Management

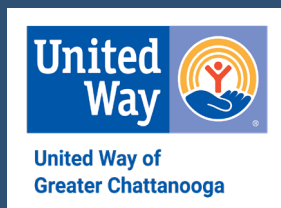
- Overview of Financial Management for Nonprofits: <https://www.councilofnonprofits.org/tools-resources/financial-management>
- For very small nonprofits: <https://blueavocado.org/hr-and-employment-issues/five-internal-controls-for-the-very-small-nonprofit/>

General Nonprofit Management

- Guidestar: www.guidestar.org
- Board Source: www.boardsource.org
- Independent Sector: www.independentsector.org
- IRS Exempt Organizations Section: www.irs.gov/charities
- National Center for Charitable Statistics: <http://nccs.urban.org/>
- Nonprofit Risk Management Center: <http://www.nonprofitrisk.org/>

SECTION 7 Frequently Asked Questions

1. What paperwork do I have to file to become a tax-exempt organization? You'll need to file paperwork both at the state and federal levels. At the state level, you will need to file Articles of Incorporation, also called a Charter, and bylaws. At the federal level, you will need to file the IRS Form 1023. The Form 1023 has several specific requirements pertaining to bylaws. Care must be taken to ensure that the organization's bylaws conform to the Form 1023's requirements, or they will have to be amended. Section Two, of this guide, provides an outline of the entire technical process of creating a tax exempt organization.
2. How long does it take to get tax exempt status? The entire start-up process generally, including receiving an IRS determination letter indicating that your organization has federal tax exempt status, can take more than 12 months. Once you have applied to the IRS for tax exempt status, your organization may wait a year or more for a response.
3. Where do I get the Form 1023? All IRS forms are available for free download on the IRS's website: <https://www.irs.gov/forms-pubs/about-form-1023-ez>.
4. How many board members should my nonprofit have? Tennessee law requires only two board members – a President and a Secretary. Board size varies widely, depending on the size of the organization, its style and the scope of its work. The leadership, expertise and governance provided by the board is far more important than its size.
5. I plan to seek grants to fund my nonprofit. Will this strategy work? As noted in Section Five, grants are an important part of a diversified fundraising base. Grants, however, are rarely given for general operating expenses and are rarely given for more than one year. Building a program on grants is generally considered to be an unsustainable strategy.
6. I want to create an endowment fund for my organization. How do I go about doing this? Endowments, or a fund in which the principal is retained and only a portion of the interest generated is used by the organization, are a part of a sustainable revenue stream for many larger or older nonprofits. Typically, funding an endowment happens after an organization has built its reputation and track record and is well-known in the community it serves. Creating an endowment for a start-up organization would be very unusual.



This guide is intended to help you decide whether developing a new nonprofit organization will be the most effective way to do your good work. If you need help deciding whether the nonprofit form is right for you or if you need assistance navigating the start-up process, please contact the Venture Forward.

www.ventureforwardnow.org

Venture Forward 630 Market Street Chattanooga, TN 37402 Phone: (423) 752-0300

