ATTRACTING U.S. DONORS
A GUIDE TO ESTABLISHING A "FRIENDS OF" ORGANIZATION IN THE UNITED STATES

JANUARY 2014

McDermott Will & Emery

THOMSON REUTERS FOUNDATION

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Thomson Reuters Foundation and McDermott Will & Emery LLP have created this Guide purely to inform and to assist its readers in learning more about incorporating a nonprofit organization in the United States. However, Thomson Reuters Foundation and McDermott Will & Emery LLP neither verify the accuracy of, nor assume liability for, the information within this Guide. The contents of this Guide are for information purposes and to provide an overview only.

This Guide does not provide legal information on all nuances involved with incorporating a nonprofit organization and is current as of November 15, 2013 only. Although we hope and believe the handbook will be helpful as background materials, we cannot warrant that it is accurate or complete, particularly as circumstances change after publication. This Guide is intended to convey only general information; therefore, it may not be applicable in all situations and should not be relied or acted upon as legal advice.

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FOREWORD

The Thomson Reuters Foundation launched TrustLaw Connect, the global pro bono service that connects NGOs and social enterprises with the best lawyers in the world, in July 2010. Our mission: spreading the practice of pro bono worldwide to drive social change.

Our goal has always been to support all kinds of socially-motivated organizations with practical legal advice. While we assist organizations with their specific individual legal needs, we also aim to share information and resources that can be of use to a wider audience. This guide is designed to fulfill just such an aim: to set out an overview of how organizations can provide tax-deductible receipts for donations received in the U.S.

By providing an overview of the key issues to consider when establishing a non-profit in the US, particularly in the form of a 'Friends Of' organization, we aim to arm social activists with the information necessary to make the process of registering as simple as possible. This guide will give you a good overview of the various decisions you will need to make in order to successfully register anywhere in the US and also provides more targeted information and highlights the various ongoing requirements of registered non-profits in a number of different states in the US.

This is one of a series of guides we have developed to assist innovators and philanthropists in the US in turning their ideas for a social organization into reality. For those that would like to consider setting up as a social enterprise rather than a traditional charity, we refer you to **"Which Legal Structure is Right for My Social Enterprise? A Guide to Establishing a Social Enterprise in the United States"**, which has been produced to complement this guide.

Though this guide is comprehensive, and great thanks go to McDermott Will & Emery for their hard work in ensuring it is, you will still need a lawyer to complete the actual registering, structuring or restructuring of your organization, but we hope this guide will help you navigate the process of registering as a non-profit in the U.S.

MONIQUE VILLA

CEO, Thomson Reuters Foundation

INTRODUCTION

The people of the United States are among the most generous donors to charitable organizations in the world. In 2012, total giving from U.S. citizens was $316.23 billion, a 1.5 percent increase over donations in 2011.[1] Moreover, in contrast with most countries, individual donors in the United States are responsible for nearly 75 percent of total giving.[2]

Despite the country's generous ethos, because contributions to non-U.S. nonprofit organizations are generally not tax-deductible, U.S. citizens are dissuaded from donating to foreign charitable organizations. Non-U.S. nonprofit organizations desiring to solicit U.S. donors will therefore need to evaluate how best to navigate this reality.

This Guide is intended to provide an overview of the options available to non-U.S. nonprofit organizations seeking donations from U.S. individual donors. The most common issue raised by non-U.S. nonprofits is whether it should form an affiliated corporation in the United States (often referred to as a "friends of" organization), which will be the primary focus of this Guide.

1 Melanie Grayce West, *Small Rise in Charitable Donations Last Year,* Wall St. J., Jun. 18, 2013, at A2

2 *Id.*

I. SHOULD I FORM A U.S. NONPROFIT ORGANIZATION?

It is important to note that because U.S. nonprofit organizations are subject to extensive federal and state regulation, establishing a separate U.S. entity or "friends of" organization can be an expensive and laborious process that requires a well thought out strategy and dedicated personnel.

As a starting point, therefore, your organization should consider the likelihood that it will be able to successfully solicit donations from U.S. individuals. First, consider the cultural aspect of attracting donors to your organization. Why would U.S. residents support your particular cause? Even if a significant number of U.S. residents might sympathize with your organization's mission, is the sympathizing population large enough (and their financial support strong enough), to be worth undergoing the process of establishing a separate U.S. entity? Second, consider the vast competition from U.S. domestic nonprofit corporations. Does a U.S. organization already exist that promotes a similar cause? If so, is the competition too strong to warrant incorporating a separate entity? If this is the case, rather than incorporating a competing nonprofit, it may be best to pursue a partnership, affiliation or joint venture with the existing U.S. organization.

Before making the decision to have a "friends of" organization formed on your behalf, you may want to consider other avenues by which you can raise funds in the United States, including soliciting donations from private foundations or trusts and/or, as noted above, aligning with a U.S. organization with a similar mission and tax-exempt status.

A ALTERNATIVE METHODS TO ATTRACTING U.S. DONORS

1 AFFILIATION WITH A U.S. TAX-EXEMPT ENTITY

As an alternative to establishing a separate "friends of" organization, your organization could pursue a fiscal sponsorship arrangement with an established U.S. tax-entity entity (also referred to as a Section 501(c)(3) entity), which can conduct fundraising activities on behalf of your organization and permit U.S. donors to qualify for U.S. income tax deductions. Though the fiscal sponsor will

need to exercise the proper discretion and control required by the United States Internal Revenue Service ("IRS"),[3] this approach would allow your organization access to U.S. donors without the burden and responsibility of incorporating a separate U.S. entity. Examples of well-known fiscal sponsors or intermediary organizations include Charities Aid Foundation America, the International Community Foundation, the King Baudouin Foundation and United Way Worldwide's International Donor Advised Giving Program.[4]

Often, fiscal sponsors are also willing to establish donor-advised funds on a donor's behalf. A donor-advised fund is not a separate public charity; rather, it is owned, controlled and administered by a public charity under an agreement with the donor, who has the right to make recommendations as to which non-U.S. nonprofit organizations will receive the distributions. The public charity overseeing the donor-advised fund assumes the burden of ongoing oversight process to ensure that the funds are being used for charitable purposes (known as "expenditure responsibility") and takes a percentage of the amount of grants distributed as a management fee.[5]

2 DONATIONS FROM PRIVATE FOUNDATIONS OR TRUSTS

In lieu of (or in addition to) establishing a separate Section 501(c)(3) entity, your organization may also consider the possibility of pursuing donations from private foundations or trusts, which are entities that receive funds from a single source (e.g., a family or corporation), rather than from the public in general. If your organization has not secured U.S. tax-exempt status, in order for a private foundation or trust to contribute funds to your organization, it would need to conduct either an "equivalency determination" or exercise "expenditure responsibility."[6]

An "equivalency determination" requires foundations to establish whether a recipient organization would qualify as tax-exempt if it were in the United States, which typically necessitates hiring a lawyer to write a legal opinion. As noted above, "expenditure responsibility" is an ongoing oversight process that requires the private foundation or trust to ensure that the donated funds are being employed for charitable purposes. As such, while pursuing this approach diminishes the administrative burden on your organization, it requires a significant undertaking by the private foundation or trust.

3 See Rev. Rul. 68-489, 1968-2 CB 210; Rev. Rul 66-79, 1966-1 CB 48.

4 See *Donor-Created Charitable Entities*, Charitable Giving: Taxation, Planning, and Strategies, ¶ 31.10 Donor-Advised Funds.

5 See http://www.usig.org/legal/types-of-gm-orgs.asp.

6 See Derek J. Aitken, *Determining Whether to Make an Equivalency Determination or to Exercise Expenditure Responsibility*, 2 INT'L J. NOT-FOR-PROFIT L. 4 (2000), *available at* http://www.icnl.org/research/journal/vol2iss4/ig_1.htm.

B ALTERNATIVE CORPORATE STRUCTURES

Before establishing a "friends of" organization, your organization may also want to explore incorporating as one of the new legal entities that are specifically designed for social enterprises. Organizational forms such as benefit corporations, low-profit limited liability companies (L3Cs) and flexible purpose corporations are intended to enable organizations to generate profits and access to a wider variety of financing options while pursuing a charitable mission. Such a mandated dual focus is attractive because it circumvents the prohibition in the Internal Revenue Code and in state law prohibiting U.S. nonprofit organizations from distributing profits (and therefore accessing equity capital markets for funding) and avoids a for-profit corporation's duty to maximize shareholder value. It is important to note though that these structures are not available in all states, and currently, there is significant variance among states regarding the structure and nature of these entities.

Though this Guide will provide a brief overview of each of these new entities, it is recommended that you also review "Which Legal Structure is Right for My Social Enterprise? A Guide to Establishing a Social Enterprise in the United States" published by the Thomson Reuters Foundation in May 2013 to obtain a more complete understanding of the new structures available.

1 BENEFIT CORPORATIONS

A benefit corporation is a new type of for-profit corporation that must recognize a public benefit as one of its corporate purposes.[7] In other words, one of the corporation's focuses must be to have a material positive impact on society and the environment. To that end, a benefit corporation is subject to strict rules of transparency and accountability about its performance in achieving this purpose, including publishing an annual report on its social and environmental performance under third party standards. Though the statutory requirements related to the third party standard vary across states, it must be developed by a person or organization that is independent from the benefit corporation. As state statutes governing benefit corporations vary widely, it is recommended that your organization consult a lawyer for guidance before pursuing this new organizational structure.

7 For more information on benefit corporations, visit the Benefit Corporation Information Center, available at http://benefitcorp.net/. Legislation authorizing benefit corporations has been enacted in Arizona, Arkansas, California, Colorado, Delaware, Hawaii, Illinois, Louisiana, Maryland, Massachusetts, Nevada, New Jersey, New York, Oregon, Pennsylvania, South Carolina, Vermont, Virginia and Washington, D.C.

2 LOW-PROFIT LIMITED LIABILITY COMPANY (L3C)

A low-profit limited liability company, or L3C, is a hybrid form of limited liability company (LLC) that confers upon an organization the same pass-through taxation benefits and liability protection of an LLC, while allowing the organization to pursue a charitable purpose foremost, rather than profit maximization. Currently, nine states — Illinois, Louisiana, Maine, Michigan, North Carolina, Rhode Island, Utah, Vermont and Wyoming — have enacted legislation or amended existing LLC statutes authorizing L3Cs, and legislation is pending or under consideration in many others. Controversy exists however as to whether L3Cs provide any real advantage over a LLC. As such, given the complexities and regulations governing L3Cs, if your organization contemplates incorporating a L3C, it is recommended that you consult a lawyer or another professional advisor for guidance.

3 FLEXIBLE PURPOSE CORPORATION

In 2012, new legislation in California became effective adopting a new for-profit corporate form referred to as the flexible purpose corporation (FPC).[8] FPCs are required to explicitly adopt one more charitable or social purposes (also referred to as "special purposes"). Moreover, if one or more of these special purposes is clearly identified in the organization's articles of incorporation and sufficient measures exist to preserve accountability and transparency, the FPC form permits its officers and directors to promote one or more of these special purposes, even at the expense of economic value. Similarly, Washington has recently established a social purpose corporation, and several other states, including Colorado and Delaware, have proposed new corporate forms that blend components of the benefit corporation and the Californian FPC. Again, given that such corporate forms are relatively new and still in development, it is recommend that your organization seek legal or other professional counsel if you elect to pursue establishing an FPC or similar corporate form.

If none of the above alternatives align with your organization's strategy and fundraising objectives, and if your organization has the requisite resources available, it should contemplate establishing a "friends of" organization, the process for which are detailed in the remainder of this Guide.

8 See California Corporations Code § 2500-3503.

II. INCORPORATING A "FRIENDS OF" NONPROFIT ORGANIZATION

In the United States, organizational structure and regulation are governed under state law rather than federal law. Thus, prior to incorporating, your organization must decide in which state it will register. For-profit enterprises often elect to incorporate in the State of Delaware because its laws offer certain tax advantages. It also has created courts focused exclusively on corporate law issues and has a wealth of well-established favorable corporate legal precedent. For nonprofit organizations, however, no one particular state stands out as especially advantageous.[9] Because of this relative parity, often the most important consideration in determining where to incorporate is convenience: Where will your organization do most of its soliciting? Where will your organization's directors and officers reside? Where will your organization's principal office be located? This Guide will highlight the incorporation procedures in California, Delaware, the District of Columbia, Illinois and New York, which represent some of the most popular jurisdictions for incorporating nonprofit organizations.

A GOVERNING LAW

Every state within the United States has statutes governing corporations organized within their jurisdiction.[10] Some states have acts specifically governing nonprofit organizations, while others have provisions within their general corporate codes articulating the regulations governing nonprofit organization. In addition, if your organization's mission promotes a particular type of charitable purpose — such as religion, healthcare or housing, among others — it is possible that other state law requirements may apply. All state acts and statutes may be amended, supplemented or repealed by the relevant state legislature at any time, and therefore, it is recommended that your organization consult a licensed lawyer within the relevant state prior to incorporation.

9 For general information regarding the number of charitable organizations incorporated within each U.S. state, see **http://nccsdataweb.urban.org/PubApps/profileDrillDown.php?rpt=US-STATE**.

10 See e.g., California Corporations Code, §§ 5110–6910; General Corporation Law of the State of Delaware, Title 8 of the Delaware Code Annotated; Title 29, Chapter 4 of the District of Columbia's Annotated Code; General Not for Profit Corporation Act, Chapter 805 of the Illinois Compiled Statutes Act 105; New York Not-for-Profit Corporation Law.

B INCORPORATION PROCESS

Though each state's specific requirements for incorporation may differ, the process is generally identical. To incorporate, your organization must first prepare and file its articles of incorporation (discussed in more detail below), and pay the designated filing fee to the appropriate state office.[11] Assuming nothing goes amiss, the relevant state filing office will file the documents and send notice to your organization's registered address confirming the successful incorporation of the nonprofit.

After incorporating, your new "friends of" organization must decide how it wishes to govern itself and draft its bylaws accordingly. Every state has a set of default rules as to how to structure a nonprofit organization, which include how to elect the board of directors and officers; how to call, hold and run board meetings; and many other issues vital to the efficient, orderly functioning of a nonprofit organization. Rather than relying on these default provisions, however, in many cases, it preferable for an organization to tailor these crucial corporate functions in its bylaws to best serve its needs. After preparing the bylaws, your "friends of" organization must hold an organizational meeting, at which it will officially elect its board of directors; elect its officers; adopt its bylaws; and create its records book, which will thereafter be updated and maintained throughout the life of the nonprofit.

1 ARTICLES OF INCORPORATION

Your "friends of" organization's articles of incorporation, or Articles (also referred to as the certificate of incorporation, certificate of formation, or corporate charter), is effectively its constitution. It is the founding document which will be filed with the state filing office as well as with the IRS to obtain tax exemption. Although specific details within the Articles vary from state to state (and often require the use of a specific state form), generally, each state will require the following details about your "friends of" organization: (i) its name; (ii) its registered agent and address; (iii) the name(s) and address(es) of its director(s); (iv) the name(s) and address(es) of its incorporator(s); and (v) a description of its corporate purposes.

It is important to note implementing revisions to your "friends of" organization's Articles is not a simple task. It requires approval from the board of directors as well as filing amendments with, and paying fees to, the state filing office. As such, it is important to draft your "friends of" organization's Articles thoughtfully and preferably with legal guidance.

11 In Illinois and California, the state filing office is the Secretary of State. In New York and Delaware, it is the Department of State, and in the District of Columbia, it is the Department of Consumer & Regulatory Affairs.

(a) Name

Most states do not allow a corporation to have the same name as an existing corporation, nor may it be deceptively similar to another corporation's name within that state. As such, before choosing a name, it is necessary to verify with the appropriate state filing office that your "friends of" organization's desired name is available, which can typically be done online on the website of the filing office.

Certain states also have required language which must be (or cannot be) included in the name. For instance, unless the corporation has a charitable or religious purpose, New York requires the corporate name to be followed by a word that identifies it as an incorporated entity,[12] and Illinois requires the name of the nonprofit entity to be followed by the acronym "NFP" if it could be construed to be a for-profit enterprise.[13] Similarly, Delaware requires that a corporation's name contain "association," "company," "corporation," "club," "foundation," "fund," "incorporated," "institute," "society," "union," "syndicate," or "limited" or an abbreviation thereof.[14] On the other hand, in California, the nonprofit organization cannot contain the word "bank," "trust," or "trustee,"[15] and in Illinois, the words "Democratic" or "Republican" and other similar political names are prohibited in the name.[16] Also, most states require a corporation's name to be in letters of the English alphabet and/or Arabic or Roman numerals.

When a non-U.S. organization incorporates a nonprofit in the United States, it is popular practice to precede its name by "American Friends of" (examples include the American Friends of the Louvre, American Friends of Tel Aviv University, and American Friends of British Art). This convention, however, is by no means required or recommended. Your organization should weigh the benefits of affiliating itself with the non-U.S. entity in the donors' minds against the further scrutiny it may draw from the IRS (discussed in more detail below).

(b) Registered Agent and Address

The Articles must include the name of the your "friends of" organization's registered agent as well as the corresponding address or "registered office". The registered address is the location at which the registered agent can receive official correspondence (e.g., official communications from the state filing office as well as process of service in legal actions) on behalf of your "friends of" organization, and it must be a specific street address, not a post office box. State rules vary regarding who may serve as a registered agent and whether the registered agent can be someone other than an individual, such as a corporation.

12 N.Y. Not-For-Profit Corp. Law § 301.

13 805 Ill. Comp. Stat. § 105/104.05(a)(2).

14 Del. Code Ann. tit. 8, § 102(a)(1).

15 Cal. Corp. Code § 5122(a), (b).

16 805 Ill. Comp. Stat. § 105/104.05(a)(6).

Some states allow the registered address to be the same address as your organization's principal place of business while others do not. It is recommended that the registered agent be a reliable party, such as an officer of your organization. If your "friends of" organization's state of incorporation is different from its principal office, it is possible for your organization to hire a registered agent from a registered agent service company to receive correspondence on behalf of your organization and notify your organization of its receipt. It is though recommended that your organization seek legal advice within the state of incorporation to ensure it properly selects a registered agent and address.

(c) Directors

The role of a nonprofit organization's board of directors cannot be underestimated. Directors are tasked with making all major corporate decisions and determining the nonprofit organization's strategy and direction. In order to perform these responsibilities, the directors must be informed about the nonprofit organization's activities and exert enough judgment and control to ensure that the organization is operating within its policies and goals. Hence, the directors of your "friends of" organization should be chosen with the utmost care and consideration.

Most importantly, each director owes a legal obligation, or a "fiduciary duty," to your organization. Although the specific duties vary by state, directors are generally required to act in the best interests of your organization, to use reasonable care in performing their duties and to be loyal to your organization. If a director acts in an unreasonable manner that causes damage to your organization or any person involved with the organization, each director may be legally liable for the amount of loss caused by the director's breach. Some states, however, offer limited immunity to uncompensated directors. In other words, in certain circumstances, directors cannot be sued and held personally liable for damage to your "friends of" organization. It is recommended that your organization seek legal counsel to review the duties of directors of nonprofit organizations in the applicable state.

States generally have very few requirements as to whom can serve as a director of a corporation. However, some states, such as New York,[17] require directors to be at least 18 years of age, while others may require directors to reside within the state of incorporation. State statutes also dictate the minimum and maximum number of directors permitted to oversee the organization. For example, California[18] and Delaware[19] require only a minimum of one director; whereas, the District of Columbia,[20] Illinois[21] and New York[22] require a minimum of three directors.

17 N.Y. Not-For-Profit Corp. Law § 702(a).

18 Cal. Corp. Code § 5220(c).

19 Del. Code. Ann. tit. 8, § 141(b).

20 D.C. Code § 29-406.03.

21 805 Ill. Comp. Stat. § 105/108.10(a).

22 N.Y. Not-For-Profit Corp. Law § 702(a).

(d) Incorporators

Most states require that organizations name at least one incorporator, who prepares and files the formation documents with the state filing office. Such individuals do not necessarily need to be otherwise affiliated with your organization. An incorporator, for example, does not need to be an officer or director of your organization. However, because incorporators typically sign corporate documents, attesting to their truth and accuracy under the penalties of perjury, many states, including Illinois[23] and New York,[24] require incorporators to be at least 18 years of age.

(e) Purpose

The most important aspect of the Articles is the articulated purpose, which gives directors and officers an explicit objective to pursue. Most state statutes, and the IRS,[25] identify specific "acceptable purposes" for nonprofit organizations and those organizations seeking federal tax-exempt status. As such, your "friends of" organization's stated purpose must both reflect the actual purpose of your organization as well as comport with the "acceptable purposes" identified under both state law and federal law. Moreover, if your organization intends to pursue federal tax-exempt status, the IRS requires specific language to be included in your organization's Articles, which may or may not be required under state law.

2 FILING FEE

Each state requires applicants to pay a filing fee (ranging from $30 to $89), and many states have specific instructions regarding the method of payment (e.g., requiring payment by cashier's check or money order). Some states, for an additional fee, offer expedited services or the opportunity to complete the filing process online. Your organization may also be required to pay an extra fee to obtain a certified copy of its Articles.

3 ADDITIONAL FILING REQUIREMENTS

After filing the necessary documents and paying the appropriate fee, the relevant state filing office will send notice to your "friends of" organization's registered address. In some states, within a certain amount of time after the Articles are filed, it is necessary to file additional documentation with the state filing office or another state office. In California, for example, within 90 days of filing an organization's Articles with the Secretary of State, a Statement of Information must also be filed, which provides additional public disclosure.

23 805 Ill. Comp. Stat. § 105/102.05.

24 N.Y. Not-For-Profit Corp. Law § 401.

25 Under federal law, "acceptable purposes" include: charitable, religious, educational, scientific, literary, testing for public safety, fostering national or international amateur sports competition, and preventing cruelty to children or animals.

4 BYLAWS

If the Articles are analogous to the constitution of an organization, then the bylaws could be considered the statutes or laws governing its internal operations. The bylaws give guidance and clarity to your organization's decision makers by outlining who has the power to make decisions; how the decision makers are selected; what the decision-making process is; and how dispute resolution should be handled, among other issues.

The bylaws cannot be inconsistent with the Articles or the applicable state law governing nonprofit organizations. It is important for those incorporating for the first time to review their state's laws and examples of bylaws from their state to ensure that all issues have been addressed and that the bylaws do not conflict with state law. Many state laws, however, contain default rules that can typically be altered by your organization's bylaws.[26] Illinois, for instance, requires a nonprofit organization to elect at least three directors; but it can elect more so long as the ability to do so is specified in the organization's bylaws. Likewise, nonprofit organizations have latitude to create officer positions based on their needs. States may though have certain requirements as to which officer positions must exist. In Illinois, there are no specific named positions that must be held, but one officer — typically referred to as the Secretary — will have the authority to certify the bylaws, board resolutions and other corporate documents as true and correct copies.[27] Your organization should review its bylaws every few years and amend them as necessary, and the procedures for doing so should be outlined in the bylaws themselves.

5 ORGANIZATIONAL MEETING

Your organization's director(s) specified in the Articles must call the first board meeting according to the process established in the bylaws. At the board meeting, your directors should:

- Ratify the Articles
- Accept their election as directors and elect additional directors, if necessary
- Adopt the bylaws
- Appoint officers
- Give authorization to set up a bank account for the corporation
- Authorize the officers to prepare and file the application for tax exemption
- Create a records book

26 805 Ill. Comp. Stat. § 105/108.10(b).

27 805 Ill. Comp. Stat. § 105/108.50(a).

Once these steps have been taken, your organization is ready to operate and pursue its objectives and should start preparing the documents to file with the IRS as soon as possible.

C STATE LAW — ONGOING RESPONSIBILITIES

1 ANNUAL FILING

On an annual or biannual basis, most states require nonprofit organizations to pay a fee and file a disclosure document with the state filing office that includes general information regarding the organization, such as its corporate name, its registered agent and address and the names of its officers and directors.[28] Failing to abide by annual reporting requirements could result in the organization being subject to late fees and penalties as well as losing its "good standing" within that state.

2 REGULAR MEETINGS AND RECORD KEEPING

At the inception of your "friends of" organization, the records book should include all of the organizational documents, such as the Articles and bylaws, as well as minutes detailing the organizational meeting. Subsequent board meetings should occur at least annually, and the minutes of those meetings should be recorded in the records book, reflecting all items discussed and decisions made. As changes to the structure of your organization occur, it will be necessary to update the bylaws and the Articles, and any such changes should be recorded in the records book.

3 AMENDMENTS TO ARTICLES OF INCORPORATION

If your organization alters its Articles (e.g., changing its name, purpose, or registered agent), it must file an amendment with the state filing office, which will typically require a fee along with the filing of the requisite documentation.

28 California, the District of Columbia and New York require biannual filing, while Delaware and Illinois require filing on an annual basis. Filing fees in these states range from $9 to $80.

III. FEDERAL TAX EXEMPT STATUS

As a U.S. nonprofit organization, the "friends of" organization will need to consider its federal income tax status. In general, nonprofit organizations are eligible to receive donor contributions without paying income tax if they have applied for, and obtained, federal income tax-exempt status under the Internal Revenue Code ("Code"). Section 501 of the Code enumerates several types of organizations that are exempt from federal income tax. While there are many subsections under Section 501 that apply to a myriad of organizations, most "friends of" organizations will qualify for exemption, if at all, under Section 501(c)(3) of the Code as a charitable, educational, religious, scientific or similar organization.

Before your "friends of" organization can obtain its federal tax-exempt status, it must first obtain a taxpayer identification number (EIN) by completing IRS Form SS-4, which is available on the IRS website,[29] or by applying online.[30]

U.S. federal income tax laws are complex. This Guide is not intended to be a comprehensive review of the federal tax laws as they related to tax-exempt organizations. It should not, therefore, be the sole authority used to plan and form your "friends of" organization. Other important sources of information include the IRS' website at http://www.irs.gov, and the IRS Publication 557 entitled Tax-Exempt Status for Your Organization, available on the IRS's website. Please consider contacting a lawyer, accountant or otherwise qualified person to assist your organization in obtaining its tax-exempt status.

29 See **http://apps.irs.gov/app/picklist/list/formsInstructions.html**.

30 See **http://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Apply-for-an-Employer-Identification-Number-(EIN)-Online**.

A SECTION 501(C)(3) ORGANIZATIONS

1 STATUTORY REQUIREMENTS OF SECTION 501(C)(3).

Section 501(c)(3) of the Code exempts from federal income tax organizations that are organized and operated exclusively for religious, charitable, scientific, literary, and education purposes, and those organizations that are organized to test for public safety, to foster national or amateur sports competition and to prevent cruelty to animals or children.

Nonprofit organizations that qualify for exemption under Section 501(c)(3) derive several key tax advantages including (i) exemption from federal income tax (other than income from a trade or business unrelated to their charitable purpose), and (ii) the ability to offer tax deductions to donors.[31]

Even if your "friends of" organization is organized and operated exclusively for one or more of the above purposes, it will not qualify as a Section 501(c)(3) organization: (i) if any part of its net earnings benefit a specific individual or a small set of individuals, such as one family or certain family members; (ii) if it attempts to influence legislation through lobbying as a substantial part of its activities; or (iii) if it participates or intervenes in any political campaign.[32] Your organization may seek, however, approval for limited lobbying expenditures without jeopardizing its tax-exempt status.

2 TAX-EXEMPT GUIDELINES

To qualify for tax-exempt status, your "friends of" organization must meet certain IRS guidelines, including the **organizational test** and **operational test** described below.

(a) The Organizational Test

To meet the organizational test, your "friends of" organization's Articles must be organized exclusively for one or more of the purposes enumerated in Section 501(c)(3). These requirements are not challenging to satisfy. Once the appropriate language is included in your organization's Articles, it continues to satisfy the organizational test and there are no further ongoing compliance issues. Organizations should exercise care, however, when drafting their Articles, bylaws and other governing documents to avoid problems under this test.

31 Most contributions to nonprofit organizations that do not qualify for exemption under Section 501(c)(3) are **not** deductible by the contributors unless such contributions qualify as business expenses incurred by private businesses.

32 Nonprofit organizations may seek approval for limited lobbying expenditures without threatening its tax exempt status.

An organization is organized "exclusively" for one or more exempt purposes only if its Articles:[33]

(i) Limit the purposes of such organization to one or more exempt purposes;

(ii) Do not expressly empower the organization to engage, other than as an insubstantial part of its activities, in activities which in themselves are not in furtherance of one or more exempt purposes;

(iii) Do not expressly empower the organization to:

  (a) Devote more than an insubstantial part of its activities to attempting to influence legislation by propaganda or otherwise;

  (b) Directly or indirectly participate or intervene in (including the publishing or distributing of statements) any political campaign on behalf of or in opposition to any candidate for public office; or

  (c) Have objectives and engage in activities that characterize it as an "action" organization; and

(iv) Permit distribution of the organization's assets, upon dissolution, only for one or more exempt purposes or to the federal, state or local government for a public purpose, or as may otherwise be determined by a court of competent jurisdiction.[34]

In addition, the Articles cannot expressly empower the organization to engage in activities which are not in furtherance of one or more of the exempt purposes for which it was formed.

(b) The Operational Test

Unlike the organizational test, the operational test is more complex and comprehensive. To satisfy this test, your "friends of" organization must be "operated exclusively" for one or more of the exempt purposes specified in Section 501(c)(3). If more than an insubstantial amount of your organization's activities do not further charitable, educational, scientific or religious activities, it will not qualify for federal income tax exemption under Section 501(c)(3). This means that it must engage primarily in activities that accomplish a tax-exempt purpose.[35]

33 For these purposes, "Articles" includes the trust instrument, the corporate charter, the articles of association, or any other written instrument by which an organization is created. Treas. Reg. § 1.501(c)(3)-1(b)(2).

34 Treas. Reg. § 1.501(c)(3)-1(b)(1), (2), (3), and (4).

35 Treas. Reg. § 1.501(c)(3)-1(c)(1).

To meet the operational test, it is recommended that your "friends of" organization avoid:

(i) Devoting a substantial part of its activities to an unrelated trade or business or for any other non-exempt purpose, like lobbying or participating in a political campaign; or

(ii) Conducting its activities primarily to benefit private individuals rather than the public.

(iii) If, however, your "friends of" organization operates a trade orbusiness as a substantial part of its activities, it may still qualify as a Section 501(c)(3) organization, so long as the trade or business furthers one or more of your corporation's exempt purposes.

Additionally, if your "friends of" organization racially discriminates in membership or in its mission, it will not qualify as a Section 501(c)(3) organization. For example, even though your "friends of" organization runs an educational center, if — for example — it refuses to admit minority children and adults, then it will not qualify for tax exemption under Section 501(c)(3). A Section 501(c)(3) organization must continue to comply with the operational test and refrain from discrimination or it could lose its tax-exempt status.

3 APPLYING FOR TAX-EXEMPT STATUS

Any organization formed after October 9, 1969, must file an application for tax exemption with the IRS to obtain recognition of its Section 501(c)(3) status.[36] Your "friends of" organization will need to complete and file IRS Form 1023, paying the applicable user fee and providing certified copies of your organization's organizational documents, with the IRS Service Center in Cincinnati in a timely manner. You should consult a lawyer or an accountant when preparing the Form 1023 for your "friends of" organization, as it often requires more than check-the-box answers. For example, Form 1023 requires a detailed narrative of your nonprofit's activities, a description of its fundraising efforts, and information about how your organization makes grants.

If your "friends of" organization desires to be tax-exempt from the first day of its existence, it must submit Form 1023 to the IRS within 27 months from the end of the month in which it was incorporated. If your "friends of" organization fails to file Form 1023 during its first 27 months, its tax-exempt status will be recognized by the IRS beginning only on the date it submitted the Form 1023 to the IRS.[37]

36 IRC §508(a); Treas Reg §1.508-1(a)(1).

37 If, however, your organization is able to provide justifiable reasons for the delay in filing and the length of such delay, the IRS may recognize your organization as being tax-exempt from the first day of its incorporation.

As part of the Form 1023 filing, the IRS strongly recommends that applicants adopt a conflict of interest policy, and has even provided a sample policy as Appendix A to the Form 1023's instructions. If your organization has not adopted a conflict of interest policy, then the IRS will request information about what procedures and safeguards your organization has implemented to protect against conflicted persons from influencing the organization, setting their own compensation, or approving interested business transactions. Such a policy helps protect against charges of impropriety involving any officers, directors or trustees and helps develop procedures that the exempt organization and the affected individual must follow when conflicts of interest arise. Repeated instances of engaging in conflicts of interest transactions could result in revocation of your "friends of" organization's tax-exempt status.

The Internal Revenue Code and the applicable Treasury regulations do not prescribe a period of time within which the IRS must rule on an organization's application for tax exemption. Currently applications are separated into three groups: (1) those that are processed immediately based on the submitted information; (2) those that require minimal additional information to be resolved; and (3) those that require additional development. If an application falls into the first or second group, an organization should expect to receive its determination letter or request for additional information within a few months. If an application falls into the third group, an organization will not be contacted until its application has been assigned to an EO specialist. As of the date of publication, the IRS had a backlog of nearly 16 months in assigning applications in the third group to an EO specialist for review.[38]

Under these circumstances, your "friends of" organization should anticipate waiting many months for its IRS determination letter. While its Form 1023 is pending, your organization may enter into a fiscal sponsorship agreement with an established Section 501(c)(3) entity, which can conduct fundraising activities on the behalf of your organization and permit U.S. donors to qualify for U.S. income tax deductions. Most such agreements terminate either at will with advance notice, or upon obtaining an IRS determination letter. Your organization could, if it so desired, function indefinitely as a program of a fiscal sponsor without forming a separate entity and applying for standalone tax exempt status.

If the application is approved, the IRS will issue a determination letter stating that your organization will be treated for tax purposes as an organization described in Section 501(c)(3). If your organization receives an adverse determination letter from the IRS, your organization may appeal by filing a sworn written protest within 30 days of receiving the adverse ruling. If your organization receives an adverse ruling from the IRS Appeals Office, the decision may be appealed to the courts after exhaustion of the organization's administrative remedies.

38 As of November 2013, the IRS is assigning applications received in May 2012. See http://www.irs.gov/Charities-&-Non-Profits/Where-Is-My-Exemption-Application.

4 PUBLIC CHARITY STATUS

By default, your "friends of" organization will be considered a private foundation unless it satisfies one of the public charity tests contained under Section 509(a). "Friends of" organizations can exist as private foundations; however, it is more advantageous to be treated as a public charity. First, being treated as a private foundation exposes your organization to several tax obligations. For example, your organization will be required to pay an excise tax on its annual net investment income (generally 2% of such income). Second, private foundations are also subject to numerous restrictions and requirements with respect to their operations and investments. Third, in addition to avoiding these restrictions and excise taxes, public charity status is generally preferable as donors receive a higher deductibility threshold (50% of adjusted gross income instead of 30% of adjusted gross income). Finally, as a private foundation, your "friends of" organization is unlikely to receive grants from other U.S.-based private foundations, which can be an important source of funding for your mission. If you believe that your "friends of" organization will be a private foundation, rather than a public charity, it is important to consult a qualified lawyer.

Your "friends of" organization will most likely attempt to qualify as a public charity because it "normally" (defined below) receives a substantial portion of its support from the public. For that reason, Section 170(b)(1)(A)(vi)'s public support test is the focus of the following discussion. An organization is "publicly supported" under Section 170(b)(1)(A)(vi) if it meets either (i) the one-third public support test; or (ii) the facts and circumstances test, both of which are briefly described below.

(a) Definition of "Normally"

Under either test, a publicly supported organization must "normally" receive the requisite amount of public support. For these purposes, "normally" is defined by reference to your organization's historic sources of support and activities.

Under the "one-third public support test," an organization is treated as normally receiving 33 ⅓ percent of its support from public sources for its current taxable year and "the taxable year immediately succeeding that year, if, for the taxable year being tested and the four taxable years immediately preceding that taxable year, the organization meets the one-third public support test on an aggregate basis."[39]

Similarly, an organization satisfies the "facts and circumstances test" for its current taxable year and the taxable year immediately succeeding that year, if, for the taxable year being tested and the four taxable years immediately preceding that taxable year, the organization meets the facts and circumstances test on an aggregate basis.[40]

39 Treas. Reg. §1.170A-9(f)(4)(i).

40 Treas. Reg. §1.170A-9(f)(4)(ii).

(b) One-Third Public Support Test

An organization is treated as a "publicly supported" organization if the total amount of "support" that it "normally" receives from public sources equals or exceeds 33 ⅓ percent of the organization's total support.

(c) Facts and Circumstances Test

An organization that fails to meet the one-third public support test may still qualify as a "publicly supported" organization if it "normally" (1) receives at least 10% of its total support from public sources ("10 percent support requirement"); and (2) is organized and operated to attract new and additional public and governmental support on a continuous basis. The IRS will consider all relevant facts and circumstances to determine if your "friends of" organization complies with this second requirement, including whether the scope of its fundraising activities is reasonable in light of its charitable activities.

In addition to satisfying these two requirements, the IRS will consider other relevant facts and circumstances to determine if your "friends of" organization qualifies as a publicly-supported organization, including the following five factors set forth in the regulations:[41]

(i) The higher the percentage of support above the 10 percent support requirement from public or governmental sources, the lesser the burden of establishing public support through other sub-factors described below;

(ii) If the organization receives support from a "representative number of persons" rather than receiving almost all of its support from a particular family's members;[42]

(iii) If the organization has a governing body that represents the broad interests of the public, rather than the personal or private interests of a limited number of donors;

(iv) If the organization provides facilities or services for the public's benefit (e.g., like a museum or library) on a continuing basis and encourages public participation in its programs or policies; and

(v) Particular factors relevant to membership organizations.

(d) Public Support, Total Support and the Two Percent Limit

To satisfy the one-third public support test or the 10 percent support requirement (under the facts and circumstances test), your organization must calculate the percent of total "support" it receives from public sources. This

41 Treas. Reg. §1.170A-9(e)(3)(ii).

42 In determining what is a "representative number of persons," consideration will be given to the type of organization involved, the length of time it has been in existence, and whether it limits its activities to a particular community or region or to a special field which can be expected to appeal to a limited number of persons.

is achieved by dividing the amount of your organization's public support (the numerator) by the amount of your organization's total support (the denominator).

An organization's total support includes: (i) gifts, grants, contributions or membership fees; (ii) net income from activities that are unrelated to its charitable mission; and (iii) gross investment income. The term "support," for these purposes, does not include amounts received by your organization from the exercise or performance of its charitable or educational purposes. These amounts are excluded from the public support percentage's denominator and numerator.

Public support, however, is limited to contributions from an individual, trust or corporation to the extent such contribution does not exceed two percent of your organization's total support for the relevant period. If a donor's contribution exceeds two percent of the organization's total support, the contribution, while fully includible in the fraction's denominator (total support), is only partially includible in the fraction's numerator (public support), up to the two-percent limit. The two percent limit does not apply to support received from governmental sources or from other publicly-supported charities under Section 170(b)(1)(a)(vi).[43]

In closing, please remember that the purpose of these public support tests is to ensure that your organization "is responsive to the general public, rather than to the private interests of a limited number of donors or other persons."[44] This is the key distinction between public charities and private foundations.

5 LIMITS ON LOBBYING

Although qualifying as a Section 501(c)(3) organization offers your "friends of" organization several advantages, it also requires that the organization comply with special rules and restrictions, including those governing lobbying.

Your "friends of" organization, generally, will not qualify as a Section 501(c)(3) organization if a **substantial part** of its activities consists of lobbying (the "substantial part test"). In determining whether such activity is "substantial," the IRS considers a variety of factors, including the extent of your organization's efforts in such activity and the amount of expenditures devoted to such activity. Engaging in excessive lobbying will expose your organization to the possibility of losing its tax-exempt status and of being subject to taxation on all of its income. In addition, the organization's members, directors and officers may be subject, jointly and severally, to a tax equal to five percent of your organization's annual lobbying expenditures if such individuals approved the lobbying

43 The two percent limit does apply, however, if contributions from a governmental organization or publicly-supported organization under Section 170(b)(1)(A)(vi) were expressly or impliedly earmarked by an initial donor as being for, or for the benefit of, the particular organization attempting to qualify under Section 170(b)(1)(A)(vi). Treas. Reg. §1.170A-9(f)(6)(v).

44 Treas. Reg. §1.509(a)-3(a)(4).

expenditures knowing that such expenditures would likely result in the loss of your organization's tax-exempt status.

As a Section 501(c)(3) organization (other than a church or a private foundation), however, your "friends of" organization may elect, as an alternative method to the substantial part test, to measure it lobbying activities by expenditures under Section 501(h) of the Code (the "expenditure test"). Under the expenditure test, your "friends of" organization may conduct a determinable annual amount of lobbying expenditures based on its exempt purpose expenditures (as determined under Section 4911 of the Code; never to exceed $1,000,000) and still retain its status as a Section 501(c)(3) organization. Your "friends of" organization's determinable annual amount will be computed in proportion to its expenditures to accomplish its exempt purposes, and it will be subject to a 25% penalty tax on any political or lobbying expenses that exceed its determinable annual amount. If your organization's lobbying expenses regularly exceed 50% of its determinable annual amount over a four-year period, your organization may lose its status as a Section 501(c)(3) organization, which will make all of its income during that period subject to tax.

If your "friends of" organization wishes to make a Section 501(h) election, it must file IRS Form 5768 and comply with additional financial and program record keeping responsibilities, including reporting the actual and permitted amounts of its lobbing and grass root expenditures. Note that a Section 501(h) election does not permit a Section 501(c)(3) organization to participate or intervene in any political campaign.

6 MAKING GRANTS TO FOREIGN GRANTEES

As a Section 501(c)(3) organization incorporated in the U.S., your "friends of" organization can make grants to foreign grantees. This subpart provides a high-level overview of the rules governing international grant making.

When making grants abroad, a tax-exempt organization must exercise discretion and control over the use of grant funds to ensure that the funds further its charitable purposes.[45] Your "friends of" organization should conduct due diligence on its foreign grantee(s), oversee and document grants made, and obtain reports on fund use. It will be important to demonstrate that the funds have been used to advance your "friends of" organization's charitable purposes.[46]

(a) General Authority to Make Grants Abroad and Deductibility Concerns

Generally, a charitable contribution is deductible only if it is made to a U.S. domestic charity. If a U.S. donor makes a gift directly to a foreign charity — without some explicit provision under the tax treaty between the U.S. and

45 Rev. Rul. 68-489, 1968-2 C.B. 2010.

46 Rev. Rul. 56-304, 1956-2 C.B., 306.

the foreign charity's home country — the donor will not be able to claim an income tax deduction. If a U.S. private foundation makes a grant to a foreign charity, which does not have its own IRS determination letter, then the private foundation will need to exercise expenditure responsibility or obtain an equivalency determination.[47]

If your "friends of" organization receives donations in the U.S., and the donor's intent was to make a gift to your overseas-based organization, the IRS will review such contribution to determine if your organization was the intended donee or if the contributions were "earmarked" to your foreign organization. If the IRS finds that your non-U.S. organization — not your "friends of" organization — is the real donee and the donations only momentarily came to rest in your "friends of" organization, then the donations to your non-U.S. organization will be considered disqualified and thus not deductible by the U.S. donors.

If instead the U.S. donor makes a contribution to your "friends of" organization and your "friends of" organization independently determines that it will transfer some or all of those funds to your non-U.S. organization, the contribution should be respected. The key is that, under this example, your "friends of" organization has informed donors that it has control over the funds and their use is subject to the discretion of your "friends of" organization. To satisfy this standard, it is recommended that your "friends of" organization:

(i) Reviews and approves grants made to foreign grantees to confirm that they are in furtherance of its own charitable purposes; and

(ii) Maintains, at all times, full control over the donated funds and discretion as to their use.

It will be important for your "friends of" organization to have directors who are U.S. citizens and who are not acting on behalf of the supported non-U.S. charity.[48] Therefore, it is likewise important that when making international grants, your "friends of" organization has appropriate governance policies in place to demonstrate that it exercises discretion and control over the solicited funds.

(b) Making International Grants as a Private Foundation

As noted above, a private foundation is subject to more limitations in terms of soliciting donations and distributing funds. In terms of international grant making, the status of the foreign grantee adds more complexity to this issue. If your "friends of" organization is a U.S. private foundation and makes grants to a foreign grantee, the grants may be taxable expenditures for purposes of Section 4945 unless the "friends of" organization exercises expenditure responsibility

47 Section 4945(h); Treas. Reg. §53.4945-5(a)(5).

48 See Rev. Rul. 66-79, 1966-1 C.B. 48.

or obtains an equivalency determination.[49] An equivalency determination made in reliance on an affidavit of the grantee organization or an opinion of counsel (of the grantor or the grantee) that the grantee is a qualifying organization will generally meet the good faith determination standard.[50]

(c) Exercising Discretion and Control

To satisfy the "discretion and control" standards described above, it is critical that your "friends of" organization conducts sufficient due diligence on foreign grantees before making any grants. An analysis of IRS guidance regarding international grant-making activities by domestic Section 501(c)(3) organizations offers the following "best practices" to ensure tax compliance:

(i) Receiving requests, perhaps annually, from the foreign charity to fund specific projects and allowing your "friends of" organization's board of directors to pre-approve those projects (rather than making general operating grants).

(ii) Conducting pre-grant review and inquiry to determine (a) if the foreign recipient can achieve the desired charitable purposes, and (b) if the foreign recipient can protect the funds from diversion to non-charitable purposes.

(iii) Documenting the grant's purposes in a written agreement which specifies the obligations of the U.S. charity and the foreign recipient.

(iv) Transmitting funds by electronic means whenever possible; by check only if electronic means are not available at reasonable cost or reliability; and by cash only where banking systems in the foreign recipient's country are not trustworthy.

(v) Obtaining written reports from the foreign recipient, at intervals specified by the U.S. charity, regarding use of the funds.

(vi) Conducting such further inquiry, including site visits by staff or volunteers, as dictated by the facts and circumstances (whether before funds have been distributed, during the grant's term, or afterwards).

These suggestions are by no means an exhaustive list, and should serve only as a starting point of forming your own policies and procedures.

(d) Accomplishing Your Grant Agreement's Intended Purposes

Written grant agreements with foreign grantees are helpful when demonstrating that your "friends of" organization is exercising discretion and control over the grants, and the grants are being used appropriately by

49 Treas. Reg. §53.4945-6(c)(2)(ii) and Treas. Reg. §53.4945-5(a)(5).

50 Rev. Proc. 92-94.

the foreign grantee. The following grant provisions should help your grant agreements pass muster with the IRS:

(i) Specify the grant's charitable purpose and limit the use of funds to that restricted purpose.

(ii) Provide that funds will not be distributed until the grantor receives a signed copy of the agreement.

(iii) Avoid making grants for general charitable support.

(iv) Make grant for specific projects and require the grantee to spend funds received only for those projects. The grantee should not apply the funds to a different project, even if entirely charitable in nature, without the grantor's prior consent.

(v) Establish specific reporting requirements and condition future support on timely receipt of satisfactory reports by the grantor.

(vi) Mandate that the grantee return funds used other than for the purposes specified in the agreement.

(vii) Execute the agreement by parties with authority to act on behalf of the grantor and grantee. Creating a "friends of" organization raises significant U.S. tax law issues for your foreign organization to consider. To avoid disallowance of donations, your "friends of" organization must have control and discretion over the funds.

7 ANTI-TERRORISM COMPLIANCE

When making grants to foreign grantees, your "friends of" organization should be aware of the anti-terrorism laws in the United States, which have become more important to international grant making. For example, in response to the attacks of September 11, 2001, Executive Order 13224 was promulgated and the USA Patriot Act of 2001 was enacted. These authorities impose civil and criminal liability on organizations and individuals for conducting transactions with an entity that the federal government associates with terrorism. Making a foreign grant to such an entity may violate the antiterrorism provisions, or ultimately lead to suspension and loss of your "friends of" organization's tax-exempt status.

To help tax-exempt organizations comply with anti-terrorism laws, the Treasury Department has issued guidelines.[51] It is recommended that your organization, at a minimum, reviews these voluntary guidelines and scans the Treasury's Office of Foreign Assets Control master list of Specially Designated Nationals.

51 See **http://www.treasury.gov/resource-center/terrorist-illicit-finance/Documents/guidelines_charities.pdf**.

B ONGOING COMPLIANCE REQUIREMENTS

Once your "friends of" organization is formed and has secured its tax-exempt status, it has ongoing compliance requirements with the IRS.

1 FILING ANNUAL RETURNS

Generally your "friends of" organization is required to file an annual information return with the IRS, with limited exceptions. If it does not file the required return or does not file it on time, penalties may be assessed. In addition, if it does not file the required return for three consecutive years, then it automatically loses its tax-exempt status.

Depending on the type of organization and its assets or revenues, your "friends of" organization may have different filing requirements, including Form 990, 990-EZ, 990-N, 990-PF and certain schedules thereto. Please visit the IRS website, or consult a lawyer or an accountant for additional details.

2 MEET SUBSTANTIATION AND DISCLOSURE REQUIREMENTS

To receive tax-deductible contributions under Section 170, your "friends of" organization must satisfy certain substantiation and disclosure requirements. In short, U.S. donors can deduct contributions to a Section 501(c)(3) organization if they have received written acknowledgement of their gift from the organization.

Under certain circumstances, the substantiation and disclosure requirements may be waived. But when required, the written disclosure statement must:

(i) Inform the donor that the amount of the contribution that is deductible for federal income tax purposes is limited to the excess of any money (and the value of any property other than money) contributed by the donor over the value of goods or services provided by the charity; and

(ii) Provide the donor with a good faith estimate of the value of goods or services that the donor received.

Once your "friends of" organization is formed and obtains the tax-exempt status, it is important to continue to observe and comply with the subsequent reporting requirements. The above listed requirements are not meant to be a complete list, and for more assistance with reporting requirements, please visit the IRS website or consult a lawyer.

IV. SOLICITATION REQUIREMENTS

A STATE CHARITABLE SOLICITATION LAWS

In addition to undergoing the incorporation process and filing to secure federal tax-exempt status, your "friends of" organization must comply with state charitable solicitation laws. These laws, found in approximately 40 states,[52] typically require a nonprofit organization to register with the relevant state charity official before it can solicit residents in that particular state for charitable contributions. State solicitation statutes also require nonprofit organizations to file episodic reports with the state charity official, likely the attorney general. Compliance with these state laws is now among the information nonprofits must annually report to the IRS.

State solicitation statutes serve two primary purposes. First, they enable state attorneys general to protect the public from deceptive fundraising practices and the misuse of charitable assets. Second, they allow states to educate donors about the nonprofit organizations soliciting contributions to enable donors to make informed donation decisions. Many states, for example, have a public database that any potential donor can access to learn more about the philanthropic organizations soliciting their funds.

This Guide provides an overview of state registration and annual reporting requirements for your newly-formed "friends of" organization seeking to solicit funds from various U.S. residents, specifically those in California, Delaware, the District of Columbia, Illinois, and New York. It also discusses the Unified Registration Statement process, the implications of internet fundraising, and state foreign corporation laws.

52 See **http://www.irs.gov/pub/irs-tege/eotopici01.pdf.**

1 ORGANIZATIONS GOVERNED BY STATE SOLICITATION LAWS

State solicitation laws generally cover all tax-exempt organization, not just 501(c)(3) organizations. It is also important to note that your "friends of" organization does not have to receive any donations in order to fall under the state solicitation registration requirements. Such laws apply to any organization that has asked for (regardless of whether they have received) contributions from the particular state's residents. Moreover, state solicitation statutes also apply to organizations that sell products to state residents and apply the proceeds toward charitable purposes instead of requesting donations.

2 GENERAL REQUIREMENTS

(a) Registration

Under most state solicitation statutes, the primary requirement is registration with the state attorney general or secretary of state before soliciting contributions in that state. The National Association of State Charity Officials ("**NASCO**") has developed a single registration form that meets the registration requirements of many states and can greatly simplify the process of registering in multiple states. If the state in which your "friends of" organization wishes to register does not accept the multistate form or your organization decides not to use it, your organization will need to file an application directly with the state attorney general's office or the state secretary of state.[53]

Though state application requirements vary, most states require:[54]

- Basic organizational information (e.g. contact information, type of legal entity and a statement of the organization's purpose)
- Financial information (e.g. gross receipts for current calendar year)
- A copy of your organizations Articles and bylaws
- Confirmation of your organization tax exempt status (i.e. IRS determination letters), its tax number, and a copy of its most recent annual filing
- Explanation of any legal proceedings involving your organization

It is important to note that the registration process may differ if your organization is registering as a resident of the state or as an out-of-state corporation. Also, most states require an application fee, which can range between $25 and $200.

53 Applications filed under state solicitation statutes will become public record.

54 Illinois requires copies of fundraiser contracts, and the District of Columbia requires a "Clean Hands Self Certification" and a tax certificate from the District of Columbia Office of Tax and Revenue.

(b) Episodic Renewal and Reporting

State solicitation laws generally require the subsequent filing of episodic reports (typically annual renewals and annual financial reports). Organizations that exceed a certain monetary amount of donations annually are often required to file reviewed and audited financial statements accompanied by a report prepared and signed by a licensed, independent public accountant. Smaller nonprofits can usually meet the financial filing requirement by submitting a copy of its IRS Form 990 or 990-EZ. Renewal and annual reporting fees commonly range between $10 and $300.

3 WHEN AND WHERE NONPROFITS SHOULD GENERALLY REGISTER

Your "friends of" organization does not need to wait until after it has received an IRS determination letter in order to register to solicit funds in U.S. states. To accelerate the process, your "friends of" organization should register in the state where the organization's main office is located during the formation process. Your organization will also have to register in any state where your request for funds will reach residents — whether in person or through mail, telephone, radio, television, etc. Web and email fundraising may trigger state registration requirements; however, currently the law is not settled yet regarding how state registration requirements interact with internet-based solicitation. When deciding where to solicit funds, your organization will want to weigh the population size of a state against its various fee requirements and the burden of its application process.

4 EXCEPTIONS TO STATE CHARITABLE SOLICITATION LAWS

Small nonprofit organizations (typically those whose annual income is less than a stated amount[55]) and certain categories of nonprofits are generally excluded or exempt from state charitable solicitation registration provided they meet specific criteria articulated in state statutes. Such organizations usually include *bona fide* religious institutions, hospitals, educational entities and libraries, and volunteer rescue and firemen organizations, among others. It is recommended that your "friends of" organization consult a lawyer or state charity officials to assess whether your organization falls under a state's exemption. It is important to note though that eleven states[56] do not require nonprofit organizations to register in order to solicit contributions from state residents.

55 In the District of Columbia, organizations with less than $1,500 of annual income are exempt from its state solicitation laws. In Illinois, the stated amount is less than $15,000, and in New York, it is less than $25,000.

56 Delaware, Idaho, Indiana, Iowa, Montana, Nebraska, Nevada, South Dakota, Texas, Vermont and Wyoming.

5 INTERNET FUNDRAISING

If your "friends of" organization employs online strategies to fundraise and request contributions, it is important to note that uncertainty exists as to whether these actions constitute "soliciting funds." Through its Charleston Principles,[57] NASCO takes the position that nonprofit organizations do not need to register with a state for a passive website that state residents simply browse. Email fundraising campaigns, which purposefully direct a charitable solicitation to a state's residents, however, would require registration under the Charleston Principles. Interactive websites, such as those with "Donate Now" buttons that allow a visitor to use a credit card to make donations, may trigger registration requirements under the principles if (i) the state's residents are specifically targeted, or (ii) the contributions the organization receives through the websites are substantial and repeated.

The Charleston Principles, however, are only recommendations. New York and New Jersey, for example, require registration for any nonprofit organization with an interactive website. While most states do not require registration because their residents are able to view a nonprofit organization's website in the state, your "friends of" organization should consult a lawyer or state charity officials to determine whether your planned Internet fundraising activities will require registration.

6 UNIFORM REGISTRATION STATEMENT

In an effort to "standardize, simplify, and economize compliance" with state solicitation laws, NASCO and the National Association of Attorneys General developed the Unified Registration Statement (URS).[58] If your potential fundraising activities will require your "friends of" organization to register in multiple states, your organization should consider completing the URS, which is a fundraising application that your organization can submit to participating states in lieu of filing that particular state's registration application.

For organizations fundraising in multiple states, the URS can greatly reduce the time and effort spent complying with varying state registration laws. For those states that require registration under charitable solicitation laws, currently, only Colorado, Florida and Oklahoma do not accept the URS. However, despite accepting the URS, many states still require the submission of specific supplemental forms and documents (e.g., your organization's IRS determination letter, articles of incorporation and bylaws, and recent IRS Forms 990 or 990-EZ), and the use of its own form for annual renewal and reporting requirements.

57 See **http://www.afpnet.org/ResourceCenter/ArticleDetail.cfm?ItemNumber=3309**.

58 See **http://www.multistatefiling.org/**.

Furthermore, because the URS was designed to meet the registration requirements of multiple states, the form is onerous and complex. Moreover, organizations leveraging the URS must submit a separate URS with original signatures to each state in which it intends to apply, and often such signatures are required to be notarized. It is therefore recommended that your "friends of" organization whether it will be engaging in solicitation in enough states to make completing the URS worthwhile, and if so, that your organization secures legal or other professional counsel to complete the requisite form.

B STATE FOREIGN CORPORATION LAWS

All states have foreign corporation laws that govern out-of-state U.S. corporations seeking to transact business within the state. Under these laws, out-of-state U.S. corporations must apply for a certificate of authority to transact business in the state. In many state, this procedure is separate from registering under charitable solicitation laws. Soliciting donations alone usually will not constitute "transacting business"; although in a few states, registering under charitable solicitation laws will trigger the need for a certificate. In most states, an out-of-state U.S. nonprofit organization will be required to apply for such a certificate if it provides services, sells goods, or has real property or employees in a state.

C CITY AND COUNTY ORDINANCES

In addition to federal and state laws regulating charitable solicitation, many cities and counties require licensing, registration and financial reporting as a condition to soliciting contributions or conducting business within their jurisdiction. Some state websites link to information on city and county solicitation requirements. As this information though can be incorrect or out-of-date, your organization should consult a lawyer or state and local officials to ensure compliance.

V. STATE AND LOCAL TAX EXEMPTION

In addition to federal income tax, your "friends of" organization will be subject to a variety of additional taxes, such as state employment taxes, state income taxes, state and local sales and use taxes, and real or personal property taxes. Receiving federal tax exemption does not exempt your organization from these state and local taxes; however, several states and municipalities grant nonprofit organization exemptions based on separate application and qualification procedures. In certain states, the combination of state and local taxes can be over 10 percent, and therefore if your "friends of" organization will make significant purchases of tangible property, or alternatively sell large amounts of tangible property, it may be worthwhile for your organization to sales and use tax exemption.

State and local exemptions from sales and use taxes vary widely depending on the state and municipality. In some states, such as California, nonprofit or exempt organizations do not have a blanket exemption from sales and use taxes. Instead, certain sales and purchases are exempt from sales and use taxes. Examples of exempt sales include, but are not limited to, sales of certain food products for human consumption, sales to the U.S. Government, sales of prescription medicines and certain vehicle and vessel transfers. In other states, such as Illinois, State and local exemptions from sales and use taxes vary widely depending on the state and municipality. In some states, such as California, nonprofit or exempt organizations do not have a blanket exemption from sales and use taxes.[59] Instead, certain sales and purchases are exempt from sales and use taxes. Examples of exempt sales include, but are not limited to, sales of certain food products for human consumption, sales to the U.S. Government, sales of prescription medicines and certain vehicle and vessel transfers. In other states, such as Illinois, only certain nonprofit organizations — those "organized and operated exclusively for charitable, religious, educational, or governmental purposes" — can qualify for exemption from state and local state taxes.[60] Your "friends of" organization should consult state departments of revenue or a lawyer for further information, if applicable.

59 See **http://www.boe.ca.gov/pdf/pub18.pdf**

60 See **http://tax.illinois.gov/Publications/PIOs/PIO-37.htm**.

FRONT COVER PHOTO A flood victim carries a sack of flour on his head from a distribution point while heading to his village of Murad Chandio, some 35 km (22 miles) from Dadu in Pakistan's Sindh province January 26, 2011. Six months after the floods raged through Pakistan, victims of one of the country's worst natural disasters are still heavily dependent on aid agencies. REUTERS / Akhtar Soomro

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