501(c)3 101

A Guide to Forming, Maintaining, and Governing a Non-Profit Corporation

*Presented by:*
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Tresquire Legal Services, PLLC

A collaboration between the DC Commission on the Arts and Humanities and the Washington Area Lawyers for the Arts
Roadmap

• What is a Non-Profit?
  o Meaning, types, categories, comparisons, and advantages

• What do I need to know before starting?
  o Requirements and considerations

• How do I set up my non-profit?
  o Procedures

• How do I “govern” my non-profit?
  o Governance and administrative policies and procedures
Not-for-profit vs. Tax Exempt

**Not-for-profit**

- Not-for-profit is a corporate classification
- A not-for-profit is formed at the state level under corporate laws for a purpose other than making a profit***

**Tax-Exempt**

- “Tax-Exempt” is a federal taxation classification
- A not-for-profit can seek tax exempt status to avoid paying federal, state, and local taxes on contributions it receives and income it earns
  - Federal Tax: must apply for tax-exempt status with the IRS
  - State & Local: Many accept an IRS determination for their own requirements

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<td>Corporations organized under Act of Congress (including Federal Credit Unions)</td>
<td>Instrumentalities of the United States Holding title to property of an exempt organization and distributing net income to it.</td>
<td>No Form</td>
<td>None</td>
<td>Yes, generally, for exclusive public purposes</td>
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<td>Exempt Organizations for The Defense of Freedom</td>
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<td>509(a)(3)</td>
<td>Religious, Educational, Charitable, Scientific, Literary, Testing for Public Safety, To Foster National or International Amateur Sports Competition, or Prevention of Cruelty to Children or Animals Organizations</td>
<td>Activities of nature implied by description of class of organization</td>
<td>1023, 1023-EZ</td>
<td>990-EZ or 990-EZ, or 990-PF</td>
<td>Yes, generally</td>
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<td>509(a)(4)</td>
<td>Organizations; and Local Associations of Employees</td>
<td>Promotion of community welfare; charitable, educational, or recreational purposes</td>
<td>Must provide notice on Form 8776 if it may also submit Form 1024-A</td>
<td>990-EZ or 990-EZ</td>
<td>No, generally 1, 14</td>
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<td>509(a)(5)</td>
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<td>1024</td>
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<td>1024</td>
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<td>Earnings devoted to charitable, fraternal and other specified purposes within a domestic lodge system. No benefits to members</td>
<td>1024</td>
<td>990-EZ or 990-EZ</td>
<td>Yes, for certain Sec. 501(c)(9) purposes</td>
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<td>Teacher Retirement Fund Associations</td>
<td>Teacher association for payment of retirement benefits</td>
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<td>1024</td>
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<tr>
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<td>No</td>
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<td>Payment of benefits under a pension plan funded by employees</td>
<td>Letter</td>
<td>990-EZ or 990-EZ</td>
<td>No</td>
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<td>509(a)(19)</td>
<td>Post or Organization of Peat or Present Members of the Armed Forces</td>
<td>Activities implied by nature of organization</td>
<td>1024</td>
<td>990-EZ or 990-EZ</td>
<td>No, generally</td>
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<td>509(a)(21)</td>
<td>Black Lung Benefit Trusts</td>
<td>Funded by coal mine operators to satisfy their liabilities for black lung or other benefits for their members</td>
<td>Letter</td>
<td>990-BL</td>
<td>No</td>
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<td>501(c)(20)</td>
<td>Withdrawal Liability Payment Fund</td>
<td>To provide funds to meet the liability of employers withdrawing from a multi-employer pension fund</td>
<td>Letter</td>
<td>990-EZ or 990-EZ</td>
<td>No</td>
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<td>501(c)(21)</td>
<td>Veterans' Organization (created before 1880)</td>
<td>To provide insurance and other benefits to veterans.</td>
<td>Letter</td>
<td>990-EZ or 990-EZ</td>
<td>No, generally</td>
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<tr>
<td>501(c)(22)</td>
<td>Title Holding Corporations or Trusts with Multiple Parent Corporations</td>
<td>Holding title and paying over income from real property to 35 or fewer parents or beneficiaries</td>
<td>1024</td>
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<td>No</td>
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<tr>
<td>501(c)(23)</td>
<td>State-sponsored Organization Providing Health Coverage for High-Risk Individuals</td>
<td>Provides health care coverage to high-risk individuals.</td>
<td>Letter</td>
<td>990-EZ or 990-EZ</td>
<td>No</td>
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<tr>
<td>501(c)(24)</td>
<td>National Railroad Retirement Investment Trust</td>
<td>Manages and invests the assets of the Railroad Retirement Account</td>
<td>Letter</td>
<td>990-EZ or 990-EZ</td>
<td>No</td>
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<td>501(c)(25)</td>
<td>CO-OP health insurance issuer</td>
<td>A qualified health insurance issuer which has received a loan or grant under the CO-OP program</td>
<td>Letter</td>
<td>990-EZ or 990-EZ</td>
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<tr>
<td>501(c)(26)</td>
<td>Religious and Apostolic Associations</td>
<td>Regular business activities; communal religious community</td>
<td>No Form</td>
<td>990-EZ or 990-EZ</td>
<td>No</td>
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<tr>
<td>501(c)(27)</td>
<td>Cooperative Hospital Service Organizations</td>
<td>Performs cooperative services for hospitals.</td>
<td>1023</td>
<td>990-EZ or 990-EZ</td>
<td>Yes</td>
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<tr>
<td>501(c)(28)</td>
<td>Cooperative Service Organizations of Operating Educational Organizations</td>
<td>Performs collective investment services for educational organizations.</td>
<td>1023</td>
<td>990-EZ or 990-EZ</td>
<td>Yes</td>
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<tr>
<td>501(c)(29)</td>
<td>Credit Counseling Organization</td>
<td>Provides credit counseling services.</td>
<td>1023</td>
<td>990-EZ or 990-EZ</td>
<td>No</td>
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<tr>
<td>501(c)(30)</td>
<td>Farmers' Cooperative Associations</td>
<td>Cooperative marketing and purchasing for agricultural products</td>
<td>1028</td>
<td>1120-C</td>
<td>No</td>
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<tr>
<td>501(d)</td>
<td>Political organizations</td>
<td>A party, committee, fund, association, etc., that directly or indirectly accepts contributions or makes expenditures for political campaigns</td>
<td>8871</td>
<td>1120-POL</td>
<td>No</td>
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26 U.S. Code Section 501

• (a) Exemption from Taxation: An organization described in subsection (c) or (d)...shall be exempt from taxation under this subtitle...

• (b) Tax on Unrelated Business Income and Certain Other Activities: An organization exempt from taxation under subsection (a) shall be subject to tax to the extent provided in parts II, III, and VI of of this subchapter...
(c) (3) Corporations, and any community chest, fund, or foundation, organized and operated exclusively for 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, no part of the net earnings of which inures to the benefit of any private shareholder or individual, no substantial part of the activities of which is carrying on propaganda, or otherwise attempting to influence legislation (except as otherwise provided in subsection (h)), and which does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of (or in opposition to) and candidate for public office.
501(c)3

Legit purposes
- Religious
- Charitable
- Scientific
- Testing for Public Safety
- Literary
- Educational
- Fostering national or international sports competitions
- Prevention of cruelty to kids/animals

Prohibitions
- Net earnings can’t benefit any individual
- No substantial part of operations can carry on propaganda or try to influence legislation
- Can’t participate or intervene in any political campaign on behalf of or against any candidate for public office

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Qualifying as Exempt

• Must be:
  
  o Organized *exclusively* for an exempt purpose (“Organizational Test”)
  
  o Operated *exclusively* for an exempt purpose (“Operational Test”)
  
  o No part of the net earnings...inures to the benefit of any private...individual (“Private Inurement Test”)
  
  o Does not participate in, or intervene in...any political campaign... (“Political Campaigns Test”)

• What does “exclusive” mean?
  
  o Nonexempt activities can't be substantial
  
  o In practice, less than 5% is ok
Organizational Test

• At a minimum, the 501(c)3’s organizing documents (the Articles of Incorporation filed with the state/District) must affirmatively:
  
  o Limit the organization’s purpose to one or more “exempt purposes”
    • Charitable, educational, religious, scientific, literary, etc
    • **”Charitable” includes promotion of the arts
  
  o Prohibit more than an insubstantial amount of nonexempt activities
  
  o Prohibit all political activities and private inurement; and
  
  o Provide, upon dissolution, all of the organization’s assets will be distributed to charity, or used for a charitable purpose
Examples of Purpose Statements

- For “Charitable Purposes”
  - Sufficient because “charitable” has a generally accepted meaning
- For “Charitable, philanthropic, and benevolent purposes”
  - Won’t pass because philanthropic & benevolent don’t have a generally accepted meaning, and so it might allow activities broader than those permitted by IRC 501(c)3
- To “Engage in research”
  - Not all research is scientific, so not really limited to exempt purposes
- To “Promote American ideals and to further the common welfare and well-being of the community”
  - Too vague and could be accomplished in a non-exempt manner, but maybe if it said “in a charitable manner”
- To “Operate a hospital”
  - May or may not be exempt depending on how it’s operated
  - Also, hospitals have to meet certain specific requirements
Operational Test

• Walk it like [you] talk it
  o No private inurement
  o Can’t benefit private parties more than incidentally
  o No substantial lobbying
  o No political activities
  o Unrelated business activities should be limited
Private Inurement Test

- **Private Inurement**
  - 501(c)3s have no “owners”
  - Any payment to an insider above fair market value can cost status

- **Excess Benefit**
  - For those cases where it’s not as extreme as private inurement
  - 25% tax on “disqualified persons” for “excess benefit transactions”
    - 200% tax if not corrected
  - “Disqualified persons include”
    - CEO, CFO, board of directors, others with substantial influence, family members of the above, of businesses that are 35% owned by any of the above
  - Revenue based compensation can be a red flag

- **Private Benefit**
  - Must operate for the benefit of the general public and avoid activities that will benefit the private interest of any individual or organization more than incidentally
  - Private Inurement is for disqualified parties, Private Benefit is for all

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What to know before starting your 501(c)3
Types of 501(c)3 Orgs

• Private Foundations—the default
  o Generally operates a principal fund managed by its trustees or directors
  o Often by a small group of people or a family
  o Doesn’t seek funding from government or public sources
  o Uses this fund to maintain or aid other charitable organizations

• Public Charities—usually the preferred option
  o Generally gets funding from the general public, receiving grants from individuals, governments, and private foundations

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Characteristics of 501(c)3s

• Limited Liability Protection

• Perpetual Existence

• Eligibility for Grants (from governments, private foundations, and private companies)

• No Owners
Advantages of 501(c)3s

- Exemption from federal income tax
- State and local property taxes also likely
- Diverse funding opportunities
  - Easier to get grants from governments, private foundations, and private companies
  - Eligible for tax deductible contributions from the public
  - May generate tax-free revenues from exempt activities and some investments
  - Still leaves room for some taxable revenue
Disadvantages of 501(c)3s

- Requires much greater transparency and facilitation of scrutiny, including immediately public accountability
  - Form 990 information return is publicly available
  - Must be able to deliver exemption application and recent 990s on request from pretty much anyone
- Higher compliance and administrative levels, especially for organizations that fundraise in multiple states
- Can’t just work to accomplish “good,” need to be vigilant about primarily focusing on exempt or charitable purposes
  - Limits on commercial or pseudo-commercial activities
  - Relationship with insiders must be closely monitored
  - Often a fine line between exempt and non-exempt
Funding a 501(c)3

- Grants
  - Often heavy lifts and competition
  - Can give you a lift in the beginning or in tough times, but might be hard to rely on
  - Grants may also come with significant restrictions and requirements

- Donations
  - Tax deductible donations are limited to 501(c)3s
  - If they give you $250 or more then you need to give them an acknowledgement letter, else they can’t claim
  - Subtract appropriate values in quid pro quos

- Sales
  - Unrelated Business Income Tax

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Unrelated Business Income Tax

• Tax exempt organizations may generate UBIT when 3 factors are met:
  o The income generated must be from a trade or business;
  o That is regularly conducted; and
  o Is not substantially related to the organization’s exempt purpose for which it was granted tax-exempt status

• Issue:
  o If these factors are met, the business will have to pay taxes at corporate levels on such earnings (currently 21%)
  o If there becomes a substantial portion of the organization’s operations, it could lose tax-exempt status
UBIT 2

• Triggers
  o Sell advertising space in a membership magazine
  o Selling items in the gift shop of a museum

• Exclusions (non-exhaustive)
  o Bingo Games
  o Public Entertainment Activity
  o Interest on certain investments
  o Royalties
  o Dividends

• “Substantial” is undefined
  o If you’re planning on working in this space, it’s wise to run things by professionals or counsel

• Filing Requirements
  o Form 990-T; like for regular business, ordinary and necessary business expenses related to this income can offset any UBIT
UBIT Case Study
Girl Scout Cookies

• Mission:
  o Build girls of courage, confidence, and character, who make the world a better place

• Those cookies though:
UBIT Case Study
Girl Scout Cookies

• Made by:
  o Little Brownie Bakers, subsidiary of Keebler (owned by Kellogg’s); and
  o George Weston Limited

• Problems:
  o Hire other people to make a product
  o Sell this product through child labor
  o License these products to other companies, for cash

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UBIT Case Study
Girl Scout Cookies

• Mission:
  o Build girls of courage, confidence, and character, who make the world a better place

• Explanation
  o Promotes their mission by teaching girls a wealth of entrepreneurial, financial literacy, and sales [wo]man skills

• Why this is tricky: rewards
Alternatives to 501(c)3

• Fiscal Sponsorship
• Donor-Advised Fund
• Different 501(c)___
• Taxable Non-Profit Corporation
Fiscal Sponsorship

• What
  o Becoming a “project” of an existing charity

• Why
  o If you’re considering a short-term charitable project, or aren’t ready for the time investment to start your own from scratch
  o Allows you to seek grants and solicit tax-deductible donations under the existing organization’s exempt status

• How
  o Create a contractual relationship with another 501(c)3 public charity, where they “sponsor” your project under their own organization
  o Usually for a fee

• Considerations
  o Donations are treated and reported as donations to the sponsoring charity
  o IRS requires the sponsoring organization to have complete discretion and control over the funds, and the IRS holds the sponsor legally responsible for making sure they’re used for an exempt purpose—not a pass-through

• See Fractured Atlas for arts based sponsorships
Donor Advised Funds

• What
  o Philanthropic vehicle established in/through a public charity. Allows donors to make a contribution, receive an immediate tax benefit, and recommend grants over time
  o Think of it as a charitable “savings account”

• Why
  o If grant making is your primary objective

• How
  o Make an irrevocable contribution of personal assets (immediate tax ded)
  o Name your DAF account, advisors, and any successors or beneficiaries
  o Contribution is places in a fund where it can be invested & grow tax free
  o At any time, you can recommend grants from the account to qualified charities

• Considerations
  o IRS is looking for people playing fishy tax games
Other 501(c)s

• Why
  o If your goals/aims/methods don’t fit perfectly within the confines, requirements, and qualifications of a 501(c)3, there may be a better solution

• What
  o Look into options like
    • 501(c)4—"Civic leagues, social welfare organizations"
    • 501(c)6—"Business leagues, chambers of commerce, boards of trade"
    • 501(c)7—"Social and recreational clubs"

• Considerations
  o Many of the limitations for 501(c)s might still be issues, like:
    • Private inurement
    • Private benefit
    • UBIT

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Taxable Non-Profit Corporation

- **What**
  - Non-profit without the tax exempt
- **Why**
  - If you’re planning a lot of commercial activity without much profit
- **Considerations**
  - Converting from taxable to tax-exempt is possible, but generates tax-liability on conversion, so you might not want to go this route
  - Private foundation grants can be available to non-501(c)3s if they meet the 501(c)3 requirements
Benefits Corporation

• Something new

• Recognized in DC, MD, and VA
Questions to Ask

- Is my organization ready to launch, or should I partner with an existing 501(c)3 “incubator”?

- Does my plan work in a 501(c)3 charity?
  - Are my projected programs charitable, educational, etc?
  - Will I be conducting the programs directly, or funding another organization to do so?
  - Who is executing the programs? Will they be paid, and if so, how much?
  - Where will the money come from?

- Am I prepared to handle the administrative, compliance, and governance responsibilities of running a 501(c)3 organization?
How Do I Set Up My 501(c)3?
How to Start a Non-Profit

• Choose a name—search for it first
• Appoint Directors
• Hold a Board Meeting
• Draft By-Laws
• Create a Conflict of Interest Policy + maybe others
• Form a State/District Entity
• Employer Identification Number (get online/SS-4)
• Apply for an IRS Tax Exemption
  o Form 1023
  o Form 1023-EZ
• Apply for a State exemption if you haven’t already, in the state you’re registered and the state where your principal office is located
• Get any necessary licenses and permits
• Get your determination letter from the IRS
By-Laws

• Create a structure for the Board
  o Voting rules
  o How a Non-Profit is governed—meetings, notices, etc
  o Says what policies you’ll have in place
  o Creates Committees
  o Creates resolutions for conflict
  o Provides for how the non-profit will dissolve

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Form 1023

• Application for recognition of Tax Exempt Status

• Two Variants
  o 1023
  o 1023-EZ

• Must file within 27 months of date of incorporation for retroactive application; otherwise only retroactive to date of submission
Form 1023-EZ

• Only available to certain entities, 3 page form allowing applicants to self-certify that they meet requirements and get speedy approval
  
  o BUT WAIT—IRS might check in, and they’d better like what they see

• Meant only for small entities
  
  o Can’t have more than $50k in each of the past 3 years, or expected in any of the next 3 years
  
  o Max assets have to be within $250k

• Who can’t use it?
  
  o LLCs
  
  o Successors to For Profit Entities
  
  o Foreign controlled organizations
  
  o Had 501(c)3 status revoked
  
  o Churches, Schools, Universities, Hospitals, Agricultural Research Organizations
  
  o Affiliated with non-501(c)3 organizations
  
  o Intend to maintain Donor Advised Funds

• Can often get an answer in 30 days

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Form 1023 “Long”

• 12 pages long, 14 pages of schedules, 38 pages of instructions (8 point font)
• IRS estimates 15.5 hours to complete
• IRS estimates 185 hours of record keeping and learning about the laws behind the 1023
• 150 Questions
  o If any of them are answered incorrectly/incompletely you’ll get follow-ups
• Will need
  o Articles of Organization, By-Laws, sample solicitations, contracts, leases, general literature
    • Be wary of trade secrets
Form 1023 Summarized

• Part I—Identification of Applicant
  o Contact, website, date of formation

• Part II—Organizational Structure
  o Articles of Organization and Board approved By-Laws

• Part III—Required Provisions in Organizing Docs
  o Must cite page & paragraph locations for purpose, dissolution, etc

• Part IV—Narrative Description of your Activities
  o Past/present/future, on an addendum

• Part VI—Beneficiaries
  o Trying to fight fraud and sneakiness

• Part VIII—History
  o Must disclose any status as a successor organization

• Part IX—Financial Data
  o Statements, expenses, and projections for 3 to 4 years

• Part X—Public Charity Status—VITAL

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DC Specific

- In DC, you need a Basic Business License for all operations, but specifically for soliciting funds.
- You can’t apply for a Basic Business License without exemption determination from the IRS.
- Ergo, you can’t solicit funds in DC without a determination letter.
- What to do? Consider Fiscal Sponsorship, or wait.

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Keeping My 501(c)3 in Compliance
Who’s Rules?

- Non-Profits & Tax-Exempt Organizations are governed by 3 groups:
  - The State in which they’re incorporated
  - The IRS
  - Charitable Solicitation Registration Laws
    - Apply for DC and 46 states
    - Definition is broad, and includes asking for donations, applying for grants, selling tickets to a fundraiser/raffle, silent auctions, and selling things to raise money (like cookies)
    - Some states require registration for internet donations
    - IRS requires notice of all states where registered if more than $25k income

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Satisfying State & IRS Requirements

- Operational Test
- By-Laws
Governance Policies

• Conflicts of Interest Policy
  o State: Usually required by Statute
  o IRS: Not required, but existence must be disclosed

• Whistleblower Policy
  o State: Often required by Statute
  o IRS: Not required, but existence must be disclosed

• Document Retention Policy
  o State: Sometimes required by Statute
  o IRS: Not required

• Compensation Review
  o State: May be required by Statute
  o IRS: Based on reasonableness, must disclose on Form 990 whether a Compensation Committee Exists, and method of determining compensation
Maintain Status

- Need to maintain Public Charity Tax-Exempt Status
  - Ensure organization’s activities continue to be charitable in nature.

- Meet Public Support Test Annually
  - For organizations described in 509(a)1:
    - **One-third Test:** Receive 1/3 of support from the government, another public charity, or a diverse group of donors; or
    - **Facts and Circumstances Test:** If between 1%-33.33% from the above sources, then has to establish that it normally receives a substantial part of its support from government or general public
  - For organizations described in 509(a)2
    - Receipt of more than one-third of ist funds generated by activities in furtherance of its exempt function
    - Limits on investment income and UBIT

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Losing Status

• Most common way to lose public charity status is not meeting the public support test for 2 years
• If you lose it, you’ll be re-classified as a private foundation
  o Subject to excise taxes, minimum distributions requirements, more forms, and other regulations
DC Specific Governance

• Biennial report is **KEY**
• Need at least 3 directors (1 in VA)
• Must have a Chief Management Officer and a Chief Financial Officer (not the same person)
• By-Laws should state term limits, otherwise default is minimum 1 and maximum 5
• Cannot use e-mail voting, polling, or proxy voting unless it’s so stated in By-Laws
• Committee types: Board Committee vs. Advisory Committee
Form 990

• Annual reporting requirement to IRS

• 3 Versions
  o 990 (Traditional)
  o 990 EZ—Short form document that works for organizations with less than $200k annual revenue, and less than $500k in assets
  o 990 N—"Postcard" form for organizations with less than $50k in revenue

• Time Commitment
  o Traditional 990s are 12 pages long, with 17 schedules, and 100 pages of instruction
  o IRS estimates it takes 75 hours to prepare, with an additional 70 hours to learn about the law
  o It’s due May 15, but you might be able to get a 6 month extension