

The background is a painting of a forest scene. It features several tall, slender trees with brown trunks and green foliage. A path or stream winds through the center of the forest. The foreground is dominated by a large, textured area of blue and green, possibly representing water or a forest floor. The overall style is impressionistic with visible brushstrokes.

**WASHINGTON
NONPROFIT
HANDBOOK**

Christina 1973

**WASHINGTON NONPROFIT
HANDBOOK:
How to Form and Maintain a Nonprofit
Corporation in Washington State
2009 Edition**

Published by
Washington Attorneys Assisting Community Organizations
and the
King County Bar Association Young Lawyers Division

Acknowledgements and Cautionary Note

We wish to express our gratitude to all of the authors and editors of the 2009 Edition of the Washington Nonprofit Handbook. This book was a collaborative project that could not have been accomplished without the good work of all contributors, including:

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Links to electronic copies of this book can be found at <http://www.kcba.org>, <http://www.waaco.org> and <http://www.washingtonlawhelp.org>.

Cover art by Christina Knowlden.

Caution: This handbook contains information about the laws impacting nonprofit organizations in Washington. But, legal information is not the same as legal advice (which involves applying laws to particular individuals and organizations and their particular circumstances). It is always a good idea to consult with an attorney to obtain advice as to how the law should be interpreted in light of the particularities of you and your organization and your situation. Also, you should be aware that laws impacting nonprofit organizations change over time such that the information contained in this handbook may become out of date.

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Non-profit corporations play tremendously important roles in the everyday life of communities all across Washington State. At the end of 2008, there were more than 56,000 non-profit corporations registered with the Corporations Division of the Washington Office of the Secretary of State. Among those, the 35,000 federally recognized charities managed over \$138 billion in assets.

For those seeking guidance in how to manage a Washington non-profit, the Nonprofit Handbook by the Young Lawyers group of the King County Bar Association and Washington Attorneys Assisting Community Organizations, provides valuable insight. This book is a practical resource for those just thinking about forming an organization that will benefit their neighbors, to those looking to wind down the non-profit corporation. It outlines management standards and offers tips for how non-profit leaders can stay in compliance with the laws and develop their organizations.

The Office of Secretary of State is a reporting agency that maintains state registrations for non-profit corporations and charitable organizations, offering a simple and inexpensive registration process. As overseer of this program, I commend the handbook's many authors for the care and knowledge they have contributed to assist those who care about Washington non-profits.

For more information about registering a non-profit with my office, please contact the specialists in our Corporations Division at (360) 725-0377 or our Charities Program at (800) 332-GIVE.

Thank you for your interest in these very important organizations,

Sincerely,



SAM REED
Secretary of State



TABLE OF CONTENTS

	Page
PART I. INTRODUCTION	1
Chapter 1. Are You Sure You Want to Do This?.....	1
Chapter 2. Alternatives to Incorporating	1
Chapter 3. Fundamental Choices.....	4
Chapter 4. Feasibility Study	6
PART II. HOW TO FORM A NONPROFIT	8
Chapter 5. Common Nonprofit Organizational Structures.....	8
Chapter 6. The Washington Nonprofit Corporation Act (Chapter 24.03 RCW).....	9
Chapter 7. Pre-Incorporation Issues	10
Chapter 8. Nuts and Bolts of Incorporating.....	12
Chapter 9. The Organizational Meeting and Post- Incorporation Tasks	23
PART III. GOVERNANCE AND OPERATIONS	26
Chapter 10. Importance of Acting Like a Corporation.....	26
Chapter 11. Function and Authority of the Board of Directors.....	27
Chapter 12. Duties and Obligations of Board Members to the Corporation	32
Chapter 13. The Role of the Executive Director	36
Chapter 14. Board Development	38
Chapter 15. Annual Reporting Requirements.....	40
Chapter 16. Entities to Report as Charitable Trusts	41
Chapter 17. Amending Governing Documents	42
Chapter 18. Sarbanes-Oxley, Document Retention, Financial Controls, Whistleblowers, and Audits	43
Chapter 19. Exposure and Risks of Directors and Officers.....	46
Chapter 20. Directors' and Officers' Insurance.....	49
PART IV. OBTAINING RECOGNITION AS A 501(C)(3) ORGANIZATION	51
Chapter 21. Considerations in Determining Whether (and When) to Seek 501(c)(3) Status.....	51
Chapter 22. Assembling Your Application	57

TABLE OF CONTENTS
(continued)

	Page
Chapter 23. Obtaining Recognition for a Publicly Supported Charity.....	70
Chapter 24. IRS Processing of Exemption Applications.....	71
PART V. MAINTAINING FEDERAL TAX-EXEMPT STATUS FOR YOUR 501(C)(3) ORGANIZATION.....	73
Chapter 25. Continuing Obligations Under Federal Tax Law.....	73
Chapter 26. Charitable Purposes	73
Chapter 27. Private Inurement.....	74
Chapter 28. Intermediate Sanctions.....	76
Chapter 29. Political Activity	78
Chapter 30. Legislative Activity (“Lobbying”).....	79
Chapter 31. Unrelated Business Income (“UBI”)	81
Chapter 32. Federal Filing Requirements.....	84
Chapter 33. Public Disclosure of Exemption Application and Form 990 Returns	86
Chapter 34. Documentation of Contributions.....	87
PART VI. INTERNATIONAL ACTIVITIES AND GRANTMAKING	89
Chapter 35. Ability of 501(c)(3) Organizations to Carry on Foreign Activities—Non-U.S. Charitable Activities Qualify as 501(c)(3) Activities.....	89
Chapter 36. Indirect Contributions of Gifts to Be Used Outside the United States—Earmarking.....	89
Chapter 37. Grants by U.S. Public Charities to Non-U.S. Organizations	92
Chapter 38. Grants by U.S. Private Foundations to Non-U.S. Organizations	93
Chapter 39. Special Treatment Accorded Canadian and Mexican Organizations	96
Chapter 40. Consequences to Foreign Recipients of Grants (Withholding Issues for Grantor).....	97
Chapter 41. Compliance With Antiterrorist Provisions.....	98
Chapter 42. Best Practices	101
PART VII. FUNDRAISING: THE OBVIOUS AND NOT-SO-OBVIOUS PITFALLS.....	102

TABLE OF CONTENTS

(continued)

	Page
Chapter 43. Charitable Solicitation in Washington	102
Chapter 44. Nonprofit Bulk Mailing Permits	110
Chapter 45. Requirements for Deducting Contributions	112
Chapter 46. Fundraising Involving Gambling	122
Chapter 47. Alcoholic Beverages at Fundraising Events	124
PART VIII. WASHINGTON STATE TAXES AND NONPROFIT CORPORATIONS	127
Chapter 48. Nonprofit Organizations Are Subject to State Taxes	127
Chapter 49. The State Business and Occupation Tax	127
Chapter 50. Local Licensing and Local B&O Taxes	138
Chapter 51. Retail Sales Tax Issues for Nonprofit Organizations	139
Chapter 52. Use Tax Issues for Nonprofit Organizations	140
Chapter 53. Property Tax Issues	142
Chapter 54. Further Information	144
PART IX. FISCAL SPONSORSHIPS, JOINT VENTURES AND OTHER COLLABORATIONS	146
Chapter 55. Working With Others	146
Chapter 56. Fiscal Sponsorships	146
Chapter 57. Joint Ventures and Other Collaborations	148
PART X. EMPLOYMENT ISSUES	152
Chapter 58. Application of Employment Law to Nonprofits	152
Chapter 59. Classification of Workers	152
Chapter 60. Antidiscrimination Laws	155
Chapter 61. Overtime Compensation	162
Chapter 62. Employee Leave Laws	166
Chapter 63. Employee Handbooks	170
Chapter 64. Other Obligations of an Organization With Respect to Employees	172
PART XI. INTELLECTUAL PROPERTY CONSIDERATIONS	174
Chapter 65. Application of Intellectual Property Law to Nonprofits	174

TABLE OF CONTENTS
(continued)

	Page
Chapter 66. Trade Names and Trademarks	175
Chapter 67. Ownership of Intellectual Property	177
PART XII. PERSONAL INFORMATION SECURITY AND ONLINE PRIVACY ISSUES FOR NONPROFIT ORGANIZATIONS.....	180
Chapter 68. Personal Information Security	180
Chapter 69. Internet Advertising and Privacy Laws.....	182
PART XIII. CEASING OPERATIONS	189
Chapter 70. Considerations Before Ceasing Operations	189
Chapter 71. Merger or Consolidation of a Nonprofit Corporation	190
Chapter 72. Dissolving a Nonprofit Corporation	192
Chapter 73. Bankruptcy	197
Chapter 74. Judicial Liquidation	199
Chapter 75. Endowment Funds	200

PART I. INTRODUCTION

Chapter 1. Are You Sure You Want to Do This?

The rest of this book explains carefully what you need to do to form and maintain a nonprofit organization. The goal for this section is to persuade you to think twice—maybe even three times—before you start down that path. There are lots of strong reasons for creating a nonprofit as a home for many sorts of work. There are also other, often simpler and less demanding, ways to get up and running. It makes sense to consider those possibilities first.

Like start-up businesses, a large proportion of new nonprofits last only a short time. The reasons they close down vary widely, but the implication is clear: starting a new organization is hard work. Surviving beyond the start-up phase depends on good fortune as well as great dedication and a good idea to build on. Most nonprofits operate on a shoestring. Gathering public support for a new organization is very difficult. Those that start without a clear path to financial stability can expect an uphill struggle.

It is important not to let the tough questions and technical details presented in this book overwhelm you. The traditions of community service and mutual support that characterize the role of nonprofits in American life have been historically a vital—even an essential—part of our communities. There are hundreds of thousands of recognized nonprofit organizations at work all across the country today. Each of them had its start in the same way: a small group of dedicated people gathered in a room somewhere who have committed to one another that they would do the work necessary to bring a new organization into being. Some started small and have remained small. They meet some specific need in some continuing way. Others have grown to be such familiar features of our communities that it is hard for us today to imagine the moment when they were nothing more than an idea and a shared vision.

Whatever the future holds for the idea that brings you to read these pages, the authors of this book wish you the best of luck and great success in your efforts to benefit the community. If these pages smooth the way for you to meet those goals, then the work of putting this book together will have been well worth it.

Chapter 2. Alternatives to Incorporating

If the previous paragraphs have given you second thoughts about whether you want to get into this, they have done their job. Unfortunately, the option of just getting on with it—starting to do the work you want to do without any formalities—is not really very attractive. For one thing, no bank is likely to open a checking account for an organization unless you can provide it with a properly executed banking resolution adopted by a board of directors. Using a personal checking account for an organization’s business, even if you are scrupulous in the way you account for every penny, invites suspicion from others involved in the project and might complicate your own personal tax situation if there should ever be a question about your personal returns. The protections against potential liability for the things your project does will not apply if there isn’t an organization with a separate legal “existence.”

This means that you are exposed to the real risk of having to spend your own money and time to defend against a lawsuit or other legal action.

Washington’s Charitable Solicitations Act (RCW 19.09) applies to all fundraising done for charitable purposes from the general public. If you are going to engage in any fundraising of that sort, it will be necessary to register with the Charities Division in Olympia (see Chapter 43) whether you are incorporated or not.

Putting a formal structure in place is a good solution for addressing many of these difficulties. Chapter 8 discusses the steps necessary to create a Washington nonprofit corporation. These steps can be accomplished pretty easily. The other parts of starting and running a business in Washington State, whether as a nonprofit or a for-profit entity, can be more difficult.

The most difficult steps in the process come later, when you apply for tax-exempt status with the Internal Revenue Service (“IRS”) (see Chapters 21-24). An organization may qualify for tax-exempt status under § 501(c)(3) of the Internal Revenue Code of 1986, as amended (the “Code”). If you expect to be supported by grants from foundations or gifts of any size from individuals, then having this status (often described as being “a 501(c)(3)”) will be especially important. Gifts to 501(c)(3) organizations usually result in a tax deduction for the donor, and most foundations will not consider a grant unless the recipient has been recognized as exempt by the IRS.

One option is to begin your work as a “program” of an already established nonprofit organization. If what you are planning to do would probably qualify for tax exemption under § 501(c)(3), for example, then you would look for a suitable 501(c)(3) organization willing to adopt your activities and provide a legal and administrative home for your project. Becoming a “program” in this sense means entering into an agreement specifying how the details of the arrangement will be handled. By starting with such an agreement, you can begin to do the work that interests you more quickly and often at less expense while leaving the details concerning the administration of a nonprofit corporation in experienced hands.

This sort of arrangement is known as “fiscal sponsorship.” There are some rules and principles of good practice that apply to such cases with special force. For advice that you may need in order to get started negotiating such an agreement once you find a suitable host, see *Fiscal Sponsorship: 6 Ways to Do It Right* by Gregory L. Colvin (San Francisco: Study Center Press, 2006). A few basics will help you decide whether to explore this option (see also further discussion in Chapter 56).

Basics of Fiscal Sponsorship
The project’s mission and purpose must be consistent with the exempt purposes of the sponsor.
The board of the sponsor is ultimately responsible for the behavior of the project and its personnel.
Donations may be made to the sponsor and earmarked for the project. If the sponsor is eligible to receive tax-deductible donations, the donor may take any permitted tax deduction.
The sponsor may provide many administrative services—human resources, accounting and payroll, planning, public relations, etc.

Many organizations have found that this kind of arrangement offers a low-cost, low-hassle way of testing the waters. The great advantage is that there is only one complicated step that must be completed before work can begin—the negotiation of the sponsorship agreement with the established organization that will house the project during its formative stages. All of the other necessary steps can wait until the viability of the new organization’s vision and mission have been tested and found to be sound.

Negotiating the sponsorship agreement will raise many of the same questions that are raised by the formation of a new organization. Are there state and local taxes that this project must be prepared to pay? How do its services fit into the definitions of eligible tax-exempt purposes in the Code? What insurance and other risk-management practices need to be in place to assure clients, staff, volunteers and supporters that due care has been taken to guard against avoidable risks and prepare for the possibilities of damage or loss (see Chapters 10, 19, 20)?

These are good questions to ask at the start of any new project. The advantage of doing so in the context of negotiating a sponsorship agreement is that there is only one other party with whom you must work. In the normal course of events, that other party is experienced in the ways of the nonprofit world and has already established relationships with the local, state and federal authorities with which you will have to deal.

Depending on the means of your organization, Washington Attorneys Assisting Community Organizations may be able to help you connect with a pro bono attorney who can assist you in working out a fiscal sponsorship agreement; see <http://www.waaco.org> for information on how to apply.

Another option in some specific circumstances may be to work with an established community foundation to put in place a program and procedures for achieving the charitable purposes that will be executed under the foundation’s auspices. This option is worth considering, for example, if the planned purposes are focused on granting scholarships, responding to the needs of people suffering from disease, or fostering research—for three examples among many possibilities. According to the Council on Foundations’ “Community Foundation Locator,” 25 such foundations were active in Washington in 2007 serving communities in every part of the state. Discussing your plans with one or several community

Basics of Fiscal Sponsorship (cont.)

Financial and other types of reporting will consolidate the activities of the project with all the other activities of the sponsor for most purposes; separate reports may be prepared for use internally and by the project.

Fiscal sponsorship agreements usually provide for payments by the project to the sponsor based on some measure of the sponsor’s services to the project.

There may be a time limit, or the sponsorship agreement may end when the project obtains federal tax-exempt status on its own.

Projects often have their own letterhead, use conventional personnel titles (such as executive director), and otherwise appear quite independent to outsiders.

There may be a policy panel that oversees and gives direction to the project; the members of this panel may provide the prototype for the board of directors that will lead the project if and when it becomes independent.

Care should be taken to fully specify the relations between this panel and the board of the sponsor.

See Chapter 56 for further discussion of fiscal sponsorship.

foundations may offer practical solutions for achieving your charitable goals without incurring the costs and administrative burdens of establishing a new nonprofit organization.

Chapter 3. Fundamental Choices

The very first choice is, of course, whether to form a nonprofit organization at all. Examination may suggest that, in some cases, your objectives can be met more efficiently and smoothly by forming some other sort of organization—such as a cooperative, a sole-proprietorship, a partnership or a for-profit corporation. Once you have determined that a nonprofit is the sort of organization that best fits your objectives, then there are some fundamental choices that you will need to make. Even if the moment of decision is some time in the future, these choices have such important and lasting consequences that you will be better off thinking carefully about them at the beginning in order to put the organization on the right track and avoid difficult changes of direction later.

Before you can complete the requirements for a new nonprofit corporation, you will need to decide whether it is to be a mutual benefit or a public benefit organization and, if it will be a public benefit organization, whether it will be exempt from federal taxes as a social welfare organization, as a public charity, or as one of the other types of organizations listed in 501(c)(3) of the Code. If your choice is to be recognized as a public charity, then you will need to take steps to ensure that it is not classified by the IRS as a private foundation—unless, of course, that is the right designation for what you want to do.

All of these questions are addressed in detail in Chapters 5, 6, 7 and 21. Before you complete the process, you will need to know a good deal about what those terms mean and how the choices you make will affect the way your new organization can work to meet its goals.

Mutual benefit organizations are formed and operate primarily for the benefit of some identifiable group, often called “members.” Examples include business leagues and condominium associations, social and recreational clubs, and “improvement” groups like mutual water companies.

Public benefit organizations include the familiar “religious, scientific, charitable and educational” groups often loosely described as “charities.” Their goals and activities confer the benefits of their work broadly on large and indefinite groups (“the people of the Puget Sound region” or “industrious youth”) or on the public at large.

Social welfare organizations are often focused on achieving their goals through advocacy and other efforts to influence public policy. Characteristically they forego the ability to accept routine foundation grants and tax-deductible donations from individuals in return for broad freedom to intervene in policy disputes without concern for the limitations the federal law imposes on the lobbying activities of charities.

Washington law offers a choice between incorporating as a standard nonprofit under rules appropriate to public benefit purposes and the more flexible rules for mutual benefit corporations (see Chapter 5).

Public charity is the name given in Internal Revenue Service regulations and publications to organizations that receive much of their financial support from operating income and relatively small donations from relatively large numbers of sources (these standards are known as the “public support test”); such organizations may apply for recognition as exempt from the federal corporate income tax and, in most cases, donors are permitted to deduct the amount of any donations to such organizations from their personal income taxes. Most public benefit organizations, unless actually formed with the goal of operating as private foundations, will want to make sure they meet the criteria for recognition as a public charity by the IRS.

Private foundations receive support from a small group of donors or operate with an endowment. They are more constrained by federal law than public charities in both their operations and their administration.

There are some more fully fundamental issues you need to work through before you begin. The first is to carefully define who will benefit and how from the work of the new organization. One powerful influence is your decision whether to have members.

Will you have members? The organizers of a new corporation can set the terms and conditions of membership in almost any way they please. Once specified in the articles of incorporation and bylaws, though, these terms and conditions must be followed carefully if the organization is to serve the community honorably and effectively. Changing the arrangements affecting members later may be difficult, especially if the impulse to do so arises at a moment of organizational crisis, when lines may be sharply drawn and suspicions aroused.

The decision over whether to be a membership organization depends on the process used for the selection of the board of directors. In the widely used associational model, the members of the organization elect the directors following a democratic process specified in the articles of incorporation or bylaws. It is impossible to summarize the variety of arrangements that have been invented to serve the needs of various sorts of organizations. Often there are eligibility and voting standards set up to assure adequate representation from various classes of membership or geographic areas. Stability is sometimes built in by having overlapping terms so the entire board is not replaced at one election. On the other end of the spectrum, many boards have limits on the length of individuals’ terms and other mechanisms to ensure turnover of directors.

Some observers maintain that it has become increasingly difficult to guarantee wide participation in organizational elections. Organizations that choose the associational form need to pay careful attention to dealing with the difficulties that would follow if the level of participation falls below that required for a valid election.

It is also common for nonprofit corporations to be formed in a way that assures continuity of leadership by providing that the board of directors will elect new members as needed following procedures that are, again, set down in the articles of incorporation or the bylaws. Such arrangements are described by saying the organization has a self-perpetuating

board. The self-perpetuating model is easier to operate but it cuts the organization off from one direct connection to the wider community.

Once you have thought these questions through, you will be in a position to design the way you want your organization to work. If you elect to begin with a fiscal sponsorship arrangement, you will want to structure your activities so you can transition smoothly to the sort of organization that will work best over the long term. When you are ready to start the task of drafting articles of incorporation and bylaws, the answers to these questions will have a large influence on what those documents say. Information needed for drafting the articles of incorporation and bylaws can be found in Chapter 8.

Because of their lasting influence on the organization these formative decisions will require careful thought in the early stages. The nub of this decision-making process will be found by posing the question: how will your new nonprofit organization ensure that it continues to serve the community long term? Specifying how the board and other stakeholders involved in the organization will work together, and how its work will accomplish its purposes and serve a wider community of interest, is the hard part of translating your vision into the paperwork required for incorporation. The time to figure that out is at the very start.

Chapter 4. Feasibility Study

Before the organization is formed, though, there is no board and no membership. A small group of enthusiasts may be convinced of the value of what they want to do. Common interests may have convinced a circle of organizers of the need for a new organization. A promising opportunity, such as an announcement of a government program or an offer of philanthropic support, may also create interest in forming a new organization. Continuing broad public support is, however, often elusive. It comes only to an organization with a well-articulated purpose, a distinctive mission and a record of effectiveness. A feasibility study offers one way to find out whether the energy of the founders will be met with the necessary sustained response from a wider group.

Feasibility studies help nonprofit organizations decide whether the time is ripe to launch a capital campaign. Similar logic applies to the question of whether to form an organization in the first place. The key questions are: Will your organization's closest and most committed supporters take the lead in assuring continuing support for its work? Is the wider community likely to join in with further support at a level that will make the planned program feasible? Hard as it is, it is better to find out that the likely answer is "no" before you and the other founders invest many hours of personal time, and no small amount of money, in putting together an organization that cannot be sustained.

Implicit in the design of a feasibility study is a fundamental truth about nonprofit organizations: They depend on the support of a core group of committed supporters for the resources they need to start up and to continue to operate. For every story about someone receiving an unexpected six-figure donation from a far-away admirer, there are thousands of stories of worthwhile organizations that simply did not have a circle of strong and willing friends who were committed to doing the day-to-day tasks necessary to keep the doors open.

A feasibility study involves testing the breadth and depth of supporters' commitment to your organization's mission and program and assessing the likelihood that other supporters can be found quickly and efficiently enough to make it possible for the organization to achieve its goals and continue to operate. Conducting a feasibility study involves describing the proposed organization to a reasonable list of current and potential supporters, listening carefully to the replies, and making a sober assessment of what has been said.

There are two strong reasons why someone from outside the circle of founders should do this work: If you ask the questions yourselves, people may be reluctant to express their doubts directly and thus may couch their answers in the gentlest possible terms. If you are optimistic about what you want to do, you may not give as much weight as you should to the cautions and doubts people express—often in veiled terms—as you are talking with them. There are consulting firms that specialize in conducting feasibility studies, and a responsible job can be done in many cases for a few thousand dollars. If the results steer you away from a frustrating run at a lost cause, the investment will have been a good one. If the consultant identifies potential supporters you would not otherwise have reached, the investment is even better.

PART II. HOW TO FORM A NONPROFIT

Chapter 5. Common Nonprofit Organizational Structures

a. Types of Nonprofit Corporations

Historically, Washington has had a number of statutes permitting the formation of nonprofit corporations. When the Washington Legislature adopted the Nonprofit Corporation Act in 1967, it repealed a number of different types of nonprofit corporations. However, several options still remain. The best option will depend on the purposes and activities of the corporation to be established. The types of nonprofit corporations include:

(i) The Washington Nonprofit Corporation Act (Chapter 24.03 RCW)

Most nonprofit corporations, particularly those that qualify as exempt from federal taxation under § 501(c)(3) of the Code, are incorporated under the Washington Nonprofit Corporation Act (the “Act”). A fuller description of the Act appears in Chapter 6.

(ii) Nonprofit Miscellaneous and Mutual Corporation Act (Chapter 24.06 RCW)

Organizations can be incorporated under Chapter 24.06 RCW, the Nonprofit Miscellaneous and Mutual Corporation Act, for any lawful purpose, including, but not limited to, mutual, social, cooperative, fraternal, beneficial, service, labor organization and other purposes. Mutual benefit organizations, such as business leagues, homeowners associations, and social and recreational clubs, may incorporate under this statute. Corporations may not be organized under this chapter for any purposes which by law are restricted to corporations organized under other statutes. These include insurance companies, banks, savings and loan associations and credit unions.

This statute is very similar to the Act. Chapter 24.06 RCW does not contain the limitations on activities and protections contained in the Act that serve to protect charitable assets, indicating the intent of the Legislature that charitable organizations be organized under the Act rather than Chapter 24.06 RCW. Additionally, unlike a corporation organized under the Act, a corporation organized under Chapter 24.06 RCW may issue shares to shareholders and may distribute surplus funds to members or shareholders. RCW 24.06.025, .070. However, Chapter 24.06 RCW specifically prohibits a corporation from engaging in any business, trade, vocation or profession for profit, although a corporation may accumulate reserves, equity, surplus or other funds through subscriptions, fees, dues or assessments or from charges made to its members or other persons for services rendered or supplies or benefits furnished or from distributing surplus funds to its members, stockholders or other persons in accordance with the provisions of the corporation’s articles of incorporation. RCW 24.06.035.

(iii) Corporations Sole (Chapter 24.12 RCW)

This chapter permits a bishop, overseer or presiding elder of a church or religious denomination in the state to incorporate for church purposes. This allows recognized

churches, particularly those with a hierarchical structure, to conduct their affairs in corporate form.

(iv) Fraternal Societies (Chapter 24.20 RCW) and Building Corporations Composed of Fraternal Society Members (Chapter 24.24 RCW)

Under Chapter 24.20 RCW, fraternal societies, lodges or chapters may incorporate by filing articles of incorporation with the Secretary of State in accordance with RCW 24.20.010. Members of fraternal societies (there must be at least ten) and fraternal societies themselves may form a separate corporation under Chapter 24.24 RCW to construct, maintain and operate a building for fraternal and social purposes.

(v) Employee Cooperative Corporations (Chapter 23.78 RCW)

This statute facilitates the ownership and control of a business by employees of the business. Under this chapter, a corporation can engage in any business in which it could engage under the Washington Business Corporation Act, Title 23B RCW. A corporation organized under this chapter is governed in large part by provisions of the Washington Business Corporation Act.

(vi) Cooperative Associations (Chapter 23.86 RCW)

Under this chapter, any number of persons may associate together as a cooperative association to operate any lawful business on the cooperative plan. Although the chapter does not define the “cooperative plan,” an agricultural cooperative probably presents the best example of such a corporation.

(vii) Other Nonprofit Corporations

Washington law provides for a number of other kinds of nonprofit corporations, many for particular kinds of activities. For example, Chapter 24.28 RCW provides for the formation of granges, Chapter 24.36 RCW permits the formation of a corporation to market fishery products, and Chapter 48.09 RCW provides for the incorporation of mutual insurance companies.

b. Charitable Trusts

A charitable trust may also be recognized as exempt from federal income tax under § 501(c)(3) of the Code. The law covering trusts, which differs in some significant ways from corporate law, will not be covered in this Handbook.

Chapter 6. The Washington Nonprofit Corporation Act (Chapter 24.03 RCW)

Most nonprofit corporations in Washington, particularly those that also qualify as exempt from federal taxation, incorporate under the Act. The Act provides the legal framework for the formation and operation of a nonprofit corporation in Washington State. As with for-profit corporations formed under the Washington Business Corporation Act,

governmental control of the activities of nonprofit corporations is accomplished through other statutes, regulations and ordinances.

The Act gives nonprofit corporations a broad range of powers. A corporation's articles of incorporation and bylaws may not grant powers in addition to those granted by the Act, although they may limit such powers. Within certain limitations described below, the powers described in the Act are as broad as those conferred on for-profit corporations. Powers include the power to purchase, own, lease, sell, convey, mortgage and otherwise deal in real and personal property, lend money or credit (except to officers and directors), make contracts, incur liabilities and borrow money, lend money for corporate purposes and invest funds, be involved in legal actions and make donations for the public welfare or for charitable, scientific or educational purposes.

The Act places several significant limitations upon nonprofit corporations. Under the Act, a nonprofit corporation may not:

- Have or issue shares of stock;
- Make any disbursement of income to its members, directors or officers; or
- Loan any money or credit to its directors or officers.

In addition, at dissolution or final liquidation, assets must be appropriately distributed. This will be described in more detail in Chapter 8 under the discussion of the articles of incorporation.

Nonprofit corporations may be organized under the Act for any lawful purpose or purposes, including, but not limited to, charitable, benevolent, eleemosynary, educational, civic, patriotic, political, religious, social, fraternal, literary, cultural, athletic, scientific, agricultural, horticultural, animal husbandry, and professional, commercial, industrial or trade purposes. The Act prohibits certain organizations from being organized under it. These include labor unions, cooperative organizations and organizations subject to any of the provisions of the banking or insurance laws of the state.

Chapter 7. Pre-Incorporation Issues

Before moving into the practical legal discussion of how to draft legal documents and incorporate, you should be aware of several organizational issues that frequently arise during the early stages of forming a nonprofit organization. It will be beneficial to you and your organization to discuss and resolve these issues in the planning stage of forming your organization. These issues fall into four categories: membership, board of directors, decision-making style and mission.

a. Membership

Under the Act, a nonprofit organization may have members or it may be a "nonmembership" corporation. Members may be persons or entities, such as corporations or limited liability companies. Under the Act, unless otherwise provided in the organization's

articles of incorporation or bylaws, members have certain voting rights. Members have the right to vote on such issues as the election of directors to the board of directors, amendments to the articles of incorporation, merger or dissolution of the corporation and several other important matters. With proper provisions in your organization's documents, you can give members the right to vote for all or only some of these purposes, or you may give members no voting rights at all.

The decision whether to have members or not and what rights to give members relates to the nature and purposes of the corporation. Membership is often considered when an organization plans to raise funds from its supporters or seeks active participation by a large group of people. Membership may help encourage supporters to volunteer for the organization because they feel a greater sense of belonging. However, some organizations may find that the burden of obtaining a membership vote to carry out certain organizational actions, such as electing directors, outweighs any benefit to having members. This problem can be particularly burdensome as an organization grows larger.

It is also important to consider the procedures under which membership rights are granted. Such considerations include the amount of notice to give members for meetings, the number of members needed to constitute a quorum, and whether voting by proxy will be permitted.

b. Board of Directors

Under the Act, the governing body of a nonprofit corporation is called the "board of directors," and the individuals who serve on the board are referred to as "directors." Sometimes nonprofit organizations call their board a "board of trustees" and refer to the members of the board as "trustees." Either form of terminology is permitted in Washington. For purposes of this Handbook, the terms "board of directors" and "directors" will be used.

The board of directors manages the business affairs of the corporation. Usually, this means that the board sets policy, adopts and oversees the budget, hires the executive director and makes other major decisions for the organization. Sometimes, particularly as organizations are just starting up, the board of directors is involved in the day-to-day management of the organization.

As you look to recruit a board of directors for your organization, you will need to decide such issues as how many directors to have on the board, how long directors will serve and what kind of individuals you want to have as directors. Factors in making these decisions include:

- Whether the board is intended to represent the community the organization will serve or the community in which the organization will be active.
- What role the board will take in fundraising. Will individual directors be asked to make a contribution, and is the contribution a significant one? Do you intend to rely upon board members for connections into resources such as businesses or foundations? Will the board be planning and putting on fundraisers for the organization?

- Whether the organization will need particular skills, such as legal or financial expertise.
- Whether the board will be setting policies on substantive issues that will become important to the organization's mission or function in its community.
- Whether there is a particularly long "learning curve" to become involved in the organization.

c. Decision-Making Style

While focusing on the role of members and directors in an organization, it is important to consider how these bodies will make decisions. This issue involves factors such as quorum (the number of persons needed to hold a meeting in which action can be taken) and numbers of votes of those present needed to take action.

Factors to be considered include whether process and consensus decision making is important to the organizers, the level of formality that will be expected in meetings or the numbers of persons expected to participate in membership and/or board meetings. For example, if larger numbers of persons are involved, you may wish to have a lower quorum number to make it easier to hold a meeting and take action. If participation by members or directors is important, you might wish to have a higher quorum number to ensure that a few active members do not make decisions. If more formality and larger numbers of persons are involved, adoption of Robert's Rules of Order or similar rules may be recommended to help keep the meetings running smoothly.

d. Mission Statement

If you have not done so, it is important to develop a mission statement for the organization. A clear, succinct mission statement becomes the basis for developing purposes of the organization, as well as a necessary tool for raising funds, recruiting directors and volunteers and planning activities and programs of the organization.

Chapter 8. Nuts and Bolts of Incorporating

The actual creation of a nonprofit corporation under Washington law is a fairly straightforward process. The basic steps discussed below will give you information on both the legal requirements and the practical tasks involved. You may find the Nonprofit Formation Checklist available online at <http://www.waaco.org> to be helpful as you are going through the process.

a. Name

If you have not done so already, you will need to choose a name for the corporation. A name signifies a message. Your organization’s name should convey a message consistent with its mission. Your corporate name should tell what your organization is about and ideally should arouse interest in your organization. Sometimes both the name and its abbreviation or acronym can convey a message. For example, both “Progressive Animal Welfare Society” and the abbreviation “PAWS” express the organization’s mission to protect animals.

Once you have chosen a name for the organization, you must determine whether some other organization already has used the name or a name similar to it. If no other organization has chosen the name, it is available for your organization’s use.

To determine whether the name is available in Washington State, you must check with the Corporations Division of the Secretary of State. It is now possible to conduct a search on the Secretary of State’s website. At the same time, you may reserve the exclusive right to use the corporate name, so that it will still be available when you file your articles of incorporation.

To confirm that a name is available and reserve an available name, you can submit (on-line, by mail or in person) a reservation request form or a letter of request to the Corporations Division with the reservation fee. You can submit up to three different names. Upon receipt of the request, the Corporations Division checks the request against its master files. The first available name is reserved for you for 180 days. The reservation can be extended once more for another 180 days. If none of the proposed names can be used or reserved, your reservation fee is returned.

Legal Requirements for a Name

While your chosen corporate name may be creative and catchy, there are certain things it cannot be under the Act. The organization’s name:

- CANNOT be the “same as or deceptively similar to” an existing or reserved corporate name, or limited partnership or limited liability company name.
- CANNOT include or end with “incorporated,” “corporation,” “company,” “incorporated,” “limited partnership,” “Ltd.,” or any other corporate designation.
- CANNOT describe the purpose of your organization in a misleading way. Any word or phrase that indicates that the corporation is organized for any purpose other than the purpose contained in the Articles of Incorporation is not permitted. For example, if your organization plans to work on AIDS, you cannot call it “The Cancer Foundation.”
- CANNOT be in a foreign language unless the name is spelled with letters from the English alphabet. For example, “El Centro de la Raza” is permitted because it is spelled with English letters.

Your organization’s name can include words such as “club,” “league,” “association,” “services,” “committee,” “fund,” “society,” “foundation,” or “[your corporate name], a nonprofit corporation.” See Chapter 56 for further discussion of fiscal sponsorship.

Finally, Chapters 65 and 66 of this book discuss intellectual property issues that you may wish to consider regarding your organization's name.

CAUTION: DO NOT order letterhead, stationary, business cards or any other printed materials with the organization's name until you have reserved the name.

b. Articles of Incorporation

(i) Generally

The articles of incorporation and the bylaws constitute the organizational and governing documents of a nonprofit corporation. The articles of incorporation create the corporation under state law. The bylaws provide the rules under that the corporation operates. The articles and bylaws should not have provisions that conflict with one another and, at best, should interrelate with one another. Except with respect to the number of directors, provisions of the articles will control over provisions of the bylaws where such provisions are inconsistent.

Sample articles of incorporation can be found online at <http://www.waaco.org>. The Secretary of State's office provides a form of articles of incorporation in which information can be written onto the form directly and the form itself filed with the Secretary of State as the corporation's articles of incorporation. This form meets state requirements for incorporation, but does not contain provisions required under federal tax law to qualify the corporation as tax-exempt under § 501(c)(3) of the Code. Therefore, if you plan to apply for tax-exempt status for your organization, do not use this form without ensuring that provisions meeting the requirements of federal tax law are attached.

(ii) Required Provisions

The Act requires that articles of incorporation include the provisions described below:

- **Name.** The name of the corporation must be listed. See the discussion above regarding the legal requirements of a corporate name.
- **Period of Existence.** You must list the period of duration of the corporation. The period is usually perpetual, but it may be limited to a specific number of years.
- **Purpose of Organization.** You must describe the purpose or purposes of the organization. Under the Act, a nonprofit corporation may be organized for any lawful purpose, including, but not limited to, charitable, benevolent, eleemosynary, educational, civic, patriotic, political, religious, social, fraternal, literary, cultural, athletic, scientific, agricultural, horticultural, animal husbandry, and professional, commercial, industrial or trade purposes. The Act prohibits certain organizations from being organized under it. These include labor unions, cooperative organizations and organizations subject to any of the provisions of the banking or insurance laws of Washington State.

Additionally, if you plan to seek tax-exempt status for your organization, you must ensure that the purposes you choose are consistent with requirements of federal tax law. A discussion of charitable and other permissible purposes for federal tax exemption appears in Chapter 21. If your purposes involve international activities, it is important to review the issues discussed in Chapters 35-42.

- **Registered Agent and Office.** You must give the name of the initial registered agent and the address of the initial registered office. The registered agent may be (i) an individual who is a Washington resident, or (ii) a nonprofit or for-profit corporation or a limited liability company. If the registered agent is a corporation or a limited liability company, it must be incorporated or formed in Washington or, if incorporated or formed in another state, it must be authorized to do business in Washington. The business office of the registered agent is the registered office of the nonprofit organization. It must be at a specific geographic location in Washington State. A post office box is permitted only if the geographic address of the registered office also is provided.

In addition, a consent form should be attached to the articles of incorporation in which the registered agent agrees to serve as registered agent of the corporation. This consent must be filed with the Secretary of State along with the articles of incorporation. An example of such consent appears at the end of the sample articles of incorporation that are available online at <http://www.waaco.org>. The form of articles of incorporation available on the Washington Secretary of State's website also contains a consent form.

- **Directors.** The board of directors serves as the governing body of the corporation and is responsible for its management and administration. The board has the ultimate responsibility of running the organization.

The Act requires that you provide the number of directors constituting the initial board of directors and the names and addresses of the persons who will serve as the initial directors. Under the Act you must have at least one individual on the initial board of directors, and you may have as many additional initial directors as you wish.

The Act requires that a board of directors be composed of one or more individuals. A corporation or other entity may not serve as a director of a nonprofit corporation under the Act. The number of directors constituting the board of directors can be provided in either the articles or bylaws. Often the articles of incorporation state that the bylaws will provide the number of directors on the board, because the bylaws are more easily amended to accommodate the changes an organization may make in the number of directors on its board over time. The number of directors is often expressed as a range between a minimum and maximum number of directors.

- **Incorporators.** The incorporators are the organizers of the nonprofit corporation. They sign and file the articles of incorporation. A nonprofit corporation may have one or more incorporators. An individual or an entity may act as an incorporator. If the incorporator is an individual, the individual must be at least 18 years of age. You must list the names and addresses of the incorporators of the corporation in the articles of incorporation.

Until the corporation is formed, any incorporator may act on behalf of the organization. Such incorporator may be personally responsible for any expenses or liabilities incurred prior to the date of incorporation if the nonprofit corporation is never formed or if the acts of the incorporator are not ratified by the board of directors. Therefore, if an incorporator makes any expenditures on behalf of the organization before it is incorporated and wishes to be reimbursed by the corporation, the incorporator must keep accurate records and receipts of any and all expenses for which he or she will seek reimbursement.

Finally, an incorporator must file accurate information with the Secretary of State. If an incorporator files documents that he or she knows contain false information, the incorporator will be guilty of a gross misdemeanor.

- **Dissolution.** You must provide the name of any person or corporation to whom net assets are to be distributed in the event the corporation is dissolved. “Net assets” are the funds and other property remaining after payment of all the debts and other liabilities of the corporation and the appropriate distribution of charitable assets.

If your organization plans to apply for status as a tax-exempt organization, there are additional requirements that apply to this provision under federal law. Federal tax law requires that upon dissolution of a 501(c)(3) organization, any remaining assets be distributed to another 501(c)(3) organization for one or more exempt purposes. The IRS requires that this requirements be stated in the articles of incorporation of a 501(c)(3) organization. See sample articles of incorporation provide language that satisfies the federal requirements. See the sample articles of incorporation available online at <http://www.waaco.org>.

(iii) Recommended Additional Provisions

In addition to the required provisions, your organization may want to include one or more of the following provisions in its articles of incorporation:

- **Director Liability Limitations.** This provision eliminates or limits the personal liability of directors of the corporation for monetary damages to the corporation for conduct as a director. The sample provision in the form of articles of incorporation limits the liability of directors to the extent permitted in Washington law. The Act forbids eliminating or limiting liability for acts or

omissions that involve intentional misconduct by a director or a knowing violation of law by such director or for any transaction from which the director will personally receive a benefit of money, property or services to which such person is not legally entitled.

- **Indemnification.** Under an indemnification provision, the corporation promises to pay expenses, liabilities and losses incurred by a director of the corporation in defending such director in any legal action in which such person becomes involved because of actions taken in his or her official capacity as a director of the corporation. A nonprofit corporation may not indemnify a director found by a court to be liable to the corporation. A sample indemnification provision is included in the sample form of articles of incorporation.
- **501(c)(3) Requirements.** An organization seeking federal tax-exempt status under § 501(c)(3) of the Code must satisfy several additional requirements in its articles. In addition to ensuring that the purposes and dissolution provisions meet federal tax law requirements, the articles must prohibit the distribution of any net earnings to members, directors, officers or other private persons and prohibit the organization from carrying on noncharitable activities. It is also recommended that the articles contain appropriate language with respect to political action and lobbying activities. The form of articles contains examples of such provisions. Again, the form articles of incorporation available through the Secretary of State's office do not contain these provisions and, therefore, should not be used if you intend to seek 501(c)(3) status for your organization, or if used should attach these provisions. In addition, a fuller discussion of these requirements is contained in Chapters 21 and 25-34.

c. Bylaws

(i) Generally

While it is not required that bylaws be prepared prior to filing the articles of incorporation with the Secretary of State, it is recommended that bylaws be drafted at the same time as the articles ensure that the documents are consistent with each other and that the particular purposes, mission and manner of acting are reflected in both of the organization's governing documents.

Bylaws contain the rules adopted for the regulation and management of your organization. The Act requires that the board of directors of a nonprofit corporation adopt bylaws for the corporation. Provisions in the bylaws may not be illegal or inconsistent with the articles. Bylaws are not filed with the Secretary of State, but are provided to the IRS with the application for 501(c)(3) status. Most bylaws outline the duties and powers of directors and officers and provide for notice, time and place of meetings. If the corporation has members, the bylaws contain rules for admission, voting rights and meetings of members. If the corporation requires members to pay dues, then the amount, method of calculation and payment dates may be stated in the bylaws or established in a separate resolution of the board of directors.

There are two forms of sample bylaws to serve as a guide in developing your organization's bylaws—a sample of bylaws for a corporation with voting members and a sample of bylaws for a corporation without members. The sample bylaws can be found online at <http://www.waaco.org>.

Bylaws can differ greatly among nonprofit organizations, reflecting the different types of nonprofit organizations and organizations' different governing structures and styles. However, when drafting bylaws, you need to pay attention to requirements in Washington law. The Act provides rules on such topics as time and place of members' and directors' meetings, voting rights, quorum, qualifications and duties of directors and removal of directors and officers. These statutory provisions act as default provisions and will govern the corporation in the absence of such provisions in the bylaws (or articles). In addition, the Act contains certain requirements that must be met by all corporations subject to the Act. These requirements will govern over any inconsistent provisions on the same subject in the bylaws or articles. Therefore, it is recommended that organizers take care to develop bylaws that will suit the purposes, activities and governing structure of the organization and meet statutory requirements.

To assist in drafting bylaws, the following information provides a description of the provisions in the Act that will govern an organization unless otherwise specified in the organization's bylaws (or articles of incorporation). That is, these are the “fallback” or “default” provisions, which are used in the event that an organization's bylaws do not address a particular topic. For example, if your organization's bylaws do not contain a provision stating the number of members needed to call a special meeting, then the number will be the number specified in the Act. Therefore, if you would like a different rule for your corporation than any of the following, you must include the rule you want in the corporation's bylaws or, in some cases, its articles.

(ii) Members

Unless otherwise provided:

- An individual, for-profit or nonprofit corporation, a general or limited partnership, an association or other entity may be a member of the organization.
- Meetings of members must be held at the registered office of the corporation in Washington State.
- A special meeting of members may be called by members having one-twentieth of the votes entitled to be cast at such meeting.
- Members of the organization may participate in a meeting of members by means of conference telephone or similar communications equipment by means of which all persons participating in the meeting can hear each other at the same time.

- Members of the organization may take any action that may be taken at a meeting of the members without a meeting if a consent, setting forth the action so taken, is executed by all of the members entitled to vote with respect to the subject matter thereof. This unanimous consent may be carried out using mail, fax or electronic mail. The written resolution (usually the consent is written as a resolution) with the signatures of the members (or return email consents) is filed with the corporate minutes.
- Notice of regular meetings other than the annual meeting need only be made by providing each member with the adopted schedule of regular meetings for the coming year at any time after the annual meeting and ten days prior to the next succeeding regular meeting and at any time when requested by a member.
- Each member has one vote on each matter submitted to members for a vote.
- Members must vote in person (proxy votes are only permitted if provided for in the bylaws).
- Members holding one-tenth of the votes entitled to be cast represented in person or by proxy (proxies are only permitted if provided for in the bylaws) shall constitute a quorum.
- A vote of the majority of the votes entitled to be cast by members present, or represented by proxy at a meeting at which a quorum is present, is necessary for any matter voted upon by the members to be legally adopted. (Note: A greater proportion may be required by the bylaws or articles and is required by the Act for certain actions.)
- Electronic communication may not be used to give notices, consents or waivers to a member unless the organization has received consent from the member.
- Elections of directors cannot be conducted by mail or electronic transmission unless provided for in the bylaws.

(iii) Board of Directors

Unless otherwise specified:

- Directors need not be residents of Washington or members of the corporation.
- Initial directors named in the articles of incorporation hold office until the first annual election of directors.
- If the articles or bylaws provide for the election of any director or directors by members, then any directors elected by members may be removed, with or without cause, by two-thirds of the votes cast by members having voting rights with regard to the election of any director, represented in person or by

proxy (if permitted by the bylaws) at a meeting of members at which a quorum is present. (Note: There are some special rules with respect to cumulative voting that should be reviewed if the organization is considering cumulative voting to elect directors.)

- A vacancy in the board and any directorship to be filled by reason of an increase in the number of directors may be filled by the affirmative vote of a majority of the remaining directors even though less than a quorum is present.
- A majority of directors constitutes a quorum. (Note: While the bylaws or articles may fix another number for a quorum, it can never be less than one-third of the number of directors.)
- The act of a majority of directors present at a meeting at which a quorum is present shall be the act of the board. (Note: (1) the bylaws or articles may provide for a greater percentage or number than a majority, and (2) the Act requires a vote of a greater number of directors for certain actions, such as a merger of the organization.)
- Directors may participate in board meetings by means of conference telephone or similar communications equipment by means of which all persons participating in the meeting can hear each other at the same time. (Note: This right is also permitted to committee members for committee meetings.)
- Directors may take action without a meeting if a consent, setting forth the action so taken, is executed by all of the directors. This unanimous consent may be carried out using mail, fax or electronic mail. The written resolution (usually the consent is written as a resolution) with the signatures of the directors (or return email consents if permitted) is filed with the corporate minutes.
- Electronic communication may not be used to give notices, consents or waivers to a director unless the organization has received consent from the director.

CAUTION: In order to qualify for an exemption from state business and occupation and/or sales taxes, an organization may be required to have a minimum number of directors and meet other requirements (see Chapter 49).

(iv) Committees

Unless specified in the bylaws (or articles), the board does not have authority to create committees of the corporation to which it may delegate its authority to manage the corporation. Additionally, in order for the delegation of authority to be effective, the committee must have at least two directors as committee members. The Act contains several statutory prohibitions related to committees that cannot be changed in the bylaws or articles:

- No committee shall have the authority of the board in reference to amending, altering or repealing the bylaws; electing, appointing or removing any

member of any such committee or any director or officer of the corporation; amending the articles of incorporation; adopting a plan of merger or consolidation with another organization; authorizing the sale, lease, or exchange of all or substantially all of the property and assets of the corporation not in the ordinary course of business; authorizing the voluntary dissolution of the corporation or revoking proceedings therefore; adopting a plan for the distribution of the corporation's assets; or amending, altering or repealing any resolution of the board which by its terms provides that it shall not be amended, altered or repealed by such committee.

- The designation or appointment of any committee and delegation to it of authority shall not operate to relieve the board or any director of any responsibility imposed by law.

(v) Officers

Unless otherwise specified:

- The officers of a corporation consist of a president, one or more vice-presidents, a secretary and a treasurer.
- Officers are elected or appointed annually by the board.
- Any officer elected or appointed may be removed by the persons authorized to elect or appoint such officer whenever in their judgment the best interests of the corporation will be served thereby.
- No person may hold two or more offices.

(vi) Other Bylaw Provisions

There are several topics for which the Act does not specifically provide and which should probably be covered in your corporation's bylaws:

- There is no procedure for the removal of directors if the organization is a non-membership corporation or does not have voting members.
- There are no required specifications for notices to directors for regular or special board meetings.
- There is no requirement of an annual meeting if the organization is a non-membership corporation or does not have voting members.
- The board has no authority to create committees to which the board may delegate the authority of the board in the management of the corporation.
- The creation of committees and their formation, composition and operation are not provided for.

- There is no specified manner or timing of attaining office for officers.
- There is no day and time fixed for the annual meetings of directors and members (this matter should be addressed in the bylaws, if applicable).

d. Conflict of Interest Policy

Pursuant to the fiduciary duty called the duty of loyalty, a director of a nonprofit corporation is required to put the interests of the corporation before his or her personal interests. A conflict of interest policy adopted by the board of directors serves to put in place procedures that will prevent a director with a conflict of interest from personally benefiting from a decision that he or she would make or participate in making. See Chapter 12 for additional discussion regarding conflicts of interest and fiduciary duties of directors. A sample conflict of interest policy is available online at <http://www.waaco.org>, as well as in Appendix A to the instructions to form 1023 published by the IRS. Alternatively, a conflict of interest policy could also be included as part of the organization’s bylaws rather than a separate policy.

e. File Articles With Secretary of State

When the articles are completed, the original of the articles of incorporation must be filed with the Secretary of State. Each of the incorporators must sign the articles, and the registered agent must sign the consent form. The filing fee required by the Secretary of State must accompany the articles. You may mail in documents, file them in person at the Secretary of State’s office in Olympia, have a records or messenger service file them for you, or file them online at the Secretary of State website. If you wish to have the filing effective on the day in which the articles are delivered to the Secretary of State, you must pay an additional fee for expedited filing. A schedule of fees is provided on the Secretary of State’s website.

If the Secretary of State finds that the articles of incorporation conform to law, the Secretary shall, when all fees have been paid:

- Endorse on the articles the word “filed” and the effective day of the filing;
- File the articles;
- Issue a certificate of incorporation to which a conformed copy shall be affixed; and
- Return the certificate of incorporation and a conformed copy affixed to it to the incorporators or their representative.

Corporate existence of a nonprofit corporation begins upon the filing of the articles. The date stamped on the articles by the Secretary of State is the effective date of incorporation.

Chapter 9. The Organizational Meeting and Post-Incorporation Tasks

a. The Organizational Meeting

After the issuance of the certificate of incorporation, a majority of the initial directors of the corporation must call an organizational meeting of the board of directors by giving at least three days' notice to the initial directors named in the articles of incorporation. The notice must state the time and place of the meeting. This notice may be waived by all the directors; if it is waived, that fact should be stated in the minutes to the organizational meeting.

You should prepare an agenda for the organizational meeting. The initial board of directors should cover the following business items, at a minimum, at the organizational meeting:

- **Adopt Bylaws.** It is helpful to the initial directors and increases the efficiency of the meeting if draft bylaws are provided to the directors well in advance of the meeting for review and comment. Many groups have found it helpful to hold a study session prior to the organizational meeting to collect comments and discuss draft documents.
- **Elect Officers.** The officer positions established in the corporation's bylaws should then be filled in the manner provided in the bylaws. Pursuant to Washington law, the officers of a nonprofit corporation consist of a president, one or more vice-presidents, a secretary and a treasurer. If permitted by the bylaws, the same person may hold one or more offices, except the offices of president and secretary.
- **Adopt a Conflict of Interest Policy.** A draft of this policy should be provided to directors prior to the meeting for review and comment. See Chapter 8.
- **Decide on a Fiscal Year.** Generally, this will coincide with the calendar year, but it is not required to do so. Often the bylaws contain a provision designating a fiscal year.
- **Select a Bank.** Choose a bank for the corporation's bank account and authorize signatories for the account. It is helpful to prepare for this by obtaining forms from the bank in advance of the meeting. The board of directors must adopt a resolution authorizing the opening of the account and signatories for the account. The bank usually will have a form resolution that you can use. The organization will need a federal employer identification number, commonly abbreviated as "EIN" or "EIN," in order to open an account. Information with respect to obtaining an EIN is provided below in subsection (b) of this Chapter.
- **Approve Any Legal Documents.** Approve initial leases and contracts, if any. Approve application for 501(c)(3) status, if prepared, and authorize execution of the form and payment of the application fee.

- **Ratify Organizers' Actions; Approve Reimbursement of Expenses.** Adopt a resolution ratifying all of the organizers' and/or incorporators' actions taken on behalf of the corporation prior to the date of incorporation and approve reimbursement of expenses, if any, upon review of the documentation of the expenses.

The secretary of the board or another designated individual should take notes during the meeting and prepare minutes for approval of the board. Upon approval of the board (usually received by motion adopted at the next meeting of the board), the minutes should be kept among the permanent records of the corporation.

The organizational meeting can occur by unanimous written consent. Unanimous written consent is a record of the resolutions made by the board of directors and signed and dated by each director or consented by a director by email. The resolutions become effective on the date on which the last signature is obtained. A copy of the executed unanimous consent should be kept among the permanent corporate records of the corporation. A sample form for a unanimous written consent for the initial meeting of the board of directors can be found online at <http://www.waaco.org>.

b. Other Organizational Tasks

Here are several steps that need to be completed after the incorporation of your organization.

- **Federal Employer Identification Number.** A federal employer identification number ("EIN") is required for the application for tax-exempt status as a 501(c)(3) organization, as well as by most banks in order to open bank accounts in the name of the corporation. The assignment of an EIN to your corporation is a fairly straightforward process. To obtain an EIN, IRS Form SS-4 must be completed and filed with the IRS. At the time of writing this book, the IRS permits completed forms to be filed online or by mail or fax. An EIN may also be obtained by a phone call to the IRS. The phone number is in the instructions to the Form SS-4. No filing fee is currently required to obtain an EIN. If the organization has a return fax number, the IRS will fax an EIN back to the organization. The Form SS-4 and instructions are available on the IRS' website.
- **Master Business Application.** Upon the filing of the articles of incorporation with the Secretary of State, the Secretary of State's office provides a packet of information regarding new corporations in Washington State, including a Master Business Application form. You may also obtain Master Business Application forms from the Department of Licensing. Completion and filing of the Master Business Application will provide your organization with its basic state tax registration and employer registration. Basic state tax registration (registration with the Washington State Department of Revenue) is required if the organization plans to engage in any business activity (which is broadly defined and may include a charitable activity that generates a

stream of revenue). The Master Business Application form will also register the corporation for payment of certain state employment taxes. These include registration with the Department of Labor and Industries and establishment of an Industrial Insurance Account and registration with the Employment Security Department for purposes of unemployment insurance.

PART III. GOVERNANCE AND OPERATIONS

Chapter 10. Importance of Acting Like a Corporation

a. Limited Liability

A nonprofit corporation is a legal entity separate and distinct from its directors, officers and employees. As such, liabilities and obligations incurred by the corporation, in the absence of unusual circumstances, must be satisfied out of the assets of the corporation and do not “pass through” to its directors, officers or employees. Put another way, a corporation provides a limited shield to its directors, officers and employees against payment of liabilities and obligations incurred by the corporation.

Notes on Terminology for Part III

The terms “director” and “board member” are used interchangeably; the terms “corporation” and “organization” are also used interchangeably; the term “officer” is used when referring to a director that has been elected to a leadership position on the board; and the term “member” is used in reference to those organizations with a membership group that has voting rights.

b. Personal Liability

In certain circumstances, a director, officer or member of a corporation may become personally liable for the corporation’s liabilities and obligations. This may occur if the corporation’s officers, directors or members fail to maintain the corporation’s separate legal identity by confusing their individual identity with that of the corporation. This confusion of identities generally occurs when one or more of the directors, officers or members of the corporation mix their personal, individual interests with the corporation’s business, often for personal gain. In such cases, a court may choose to disregard the corporate entity created and hold the individuals acting on behalf of the corporation (i.e., the directors, officers or members) personally responsible for the corporation’s liabilities and obligations. A court may choose to impose personal liability in this manner even though articles of incorporation creating the corporation, which limit an individual’s liability, have been filed.

Courts and the Internal Revenue Service (“IRS”) give particular scrutiny to cases involving a small number of individuals who fill multiple roles within the corporation, which is very common for a new nonprofit corporation. In deciding whether liabilities and obligations of a corporation will “pass through” to officers or directors, courts and the IRS scrutinize the corporation and its operation to decide if the corporation meets certain minimum standards for consideration as a separate entity. For instance, courts examine whether the corporation has adequate funds to pay its creditors, whether the individuals commingled corporate and personal funds on a regular basis, whether the individuals failed to keep proper corporate records and whether the corporation generally failed to act like a corporation. The IRS may assess taxes and penalties personally against the corporation’s principals if it concludes the corporation is not a valid separate entity.

A principal of a corporation (usually an officer or director) may also become personally liable for the liabilities of the corporation if the individual fails to make clear to persons with whom he or she is dealing that he or she is in fact acting as an agent of the

corporation and not as an individual. All business transactions of a corporation should clearly indicate that they are corporate transactions, and the representative capacity of the officers or directors acting on behalf of the corporation should always be disclosed.

c. Preventative Action

To ensure that a nonprofit corporation is considered a separate entity, regular meetings for both the board of directors and members (if it is a membership organization) should be held meticulously. The board should also ensure that written minutes of these meetings are prepared and placed in the corporate record book. Nonprofit corporations should also be especially diligent in maintaining sufficient funds to pay their debts and in segregating corporate funds from the personal funds of the corporation's officers and directors. A failure to segregate funds could also result in loss of tax-exempt status. See the discussion in Chapter 27 on private inurement.

In all dealings on behalf of a nonprofit corporation, a director or officer should clarify the capacity in which he or she is acting. In addition, all signatory lines for contracts and other documents should identify the corporation by its full legal name together with the title of the officer or director signing the document. If the name of the corporation and the title of the signatory are not written above or under the signature line, the officer or director should add these by hand under his or her signature.

The following chapters illuminate the importance of explicit and robust policies, systems, and procedures for a nonprofit corporation; clearly defined roles and responsibilities for directors, officers, staff, and volunteers; and open and trusting relationships among all individuals and stakeholder groups. These practices will preserve the corporate entity and enable it to work more effectively to accomplish your organization's mission.

Chapter 11. Function and Authority of the Board of Directors

Operating a nonprofit organization is a complex undertaking that involves multiple stakeholders, including board members, the executive director and other staff, volunteers, persons being served, and funders. The board of directors is responsible for setting overall priorities and ensuring that resources are used wisely in pursuit of the organization's mission.

Under the Act, a nonprofit corporation's board of directors is the governing body of the corporation and is responsible for managing the affairs of the corporation. The board may delegate certain of its responsibilities to committees and officers of the corporation, but the board retains ultimate responsibility for the corporation. A corporation exercises its powers through resolutions and acts of the board. Generally, the board delegates the day-to-day responsibilities of operating the corporation to paid or volunteer staff members.

a. Election, Number of Directors, and Board Terms

Under the Act, a corporation's board of directors must be composed of at least one individual. The articles of incorporation ("articles") or bylaws establish the number of and election method of the directors. The number of directors may be a range (e.g., "not less than seven or more than 15") and may be increased or decreased by amending the document that

specifies the number. An amendment that decreases the number of directors cannot shorten the term of any current director. The articles or bylaws may provide that directors will be elected by the corporation's members or by the corporation's directors; in some circumstances, directors may be appointed.

The articles or bylaws specify the directors' terms of office. Terms can be for one year or several years. Nonprofit corporations typically choose terms of two or three years for their directors. Each director holds office until his or her successor has been selected and qualified. The term of the directors may be staggered by providing that only some portion of the board seats are up for election at the same time. Staggering the directors' terms can provide valuable continuity on the board.

If the corporation has a membership with voting rights, the articles or bylaws may require that directors be elected by a majority vote of the corporation's members. Alternatively, the articles or bylaws may provide for a more complex manner of electing directors known as "cumulative voting." Cumulative voting permits each member or director entitled to vote to add all of the votes to which he or she is entitled and apply them toward one candidate's election or distribute the votes among several candidates.

b. Action by the Board

To be a valid act of the corporation, the act must be approved by a majority of the directors at a board meeting in which a quorum is present. Unless the corporation's articles or bylaws state otherwise, a majority of the directors constitutes a quorum. A quorum may not be less than one-third of the total number of directors. The articles or bylaws may require a greater proportion of votes for certain acts by the board, such as the removal of a director or modification of the corporation's purpose.

A director may vote against (i.e., dissent) or not vote on (i.e., abstain) an action taken by the board. However, if the director is present at the meeting where the action is taken, it is assumed that the director consented to the action unless the director's dissent or abstention is recorded in the minutes or filed in writing with the Secretary of the corporation.

Directors cannot appear by proxy or give their proxies to another director. Directors must be present to listen to the discussion, consider each resolution, and vote based on their judgment.

c. Removing Directors and Vacancies on the Board

A corporation's articles or bylaws may contain a procedure for removing directors. If the articles or bylaws provide for the election of any directors by members, yet fail to specify a procedure for removal, the Act specifies the following:

- Any director elected by members may be removed by two-thirds of the votes cast by members having voting rights with regard to director elections, at a meeting where a quorum is present. Note that members may be represented in person or by proxy, if permitted by the bylaws (even though this option is not available to directors).

- If a corporation has cumulative voting, a director may be removed if the number of votes cast for removal would have elected the director at an election.
- If a corporation has no members and no removal procedure is specified in the bylaws, the corporation must go to court to effect the removal of a director.
- If the articles or bylaws do not specify a procedure to fill a vacancy on the board, then a majority of the remaining directors may elect a new director. The new director that is elected or appointed completes the unexpired term of the vacant position.

d. Committees

The board may designate and appoint committees to perform certain activities of the corporation, if the articles or bylaws allow for the creation of such committees. However, even if the board appoints a committee and delegates certain of its duties to the committee, the board and individual directors remain ultimately responsible for duties imposed by law. Additionally, in order for a committee to have delegated authority, it must have at least two directors as committee members.

The Act prohibits the board from delegating certain powers or responsibilities to committees. Committees cannot:

- Amend, alter, or repeal the corporation's articles or bylaws;
- Elect, appoint, or remove any member of the committee, nor any director or officer of the corporation;
- Adopt a plan of merger with another corporation;
- Authorize the sale, lease, or exchange of substantially all of the corporation's assets;
- Authorize the dissolution of the corporation;
- Adopt a plan for distribution of the corporation's assets; or
- Amend, alter, or repeal any board resolution that by its terms may not be amended, altered, or repealed by a committee.

e. Meetings

Nonprofit corporations with members must hold at least one annual meeting for members and one annual meeting for directors. Although corporations without members are not required to hold an annual board meeting, it is recommended that one be held. The annual member meeting is typically held for the purpose of electing directors for the next year and for discussion of general business matters. The annual board meeting is typically held for the

purpose of electing directors (unless directors are elected by members), electing or appointing officers for the coming year, adopting the corporation's budget, approving programs/activities, and forming plans and strategies. Holding an annual meeting ensures that elections necessary to elect directors and officers take place.

The corporation must give notice of the annual meeting to members using one of the methods approved in the bylaws no less than 10 or more than 50 days prior to the meeting. The corporation's bylaws establish the date of the annual meeting of members and directors for membership corporations and of directors for nonmembership corporations. Failure to hold an annual meeting at the designated time required under the corporation's bylaws will not bring about a dissolution of the corporation, but it does put the corporation out of compliance with its bylaws and, as such, should be remedied as soon as possible by the board.

Beyond the annual board meeting, most boards will establish a schedule of monthly or quarterly meetings. The bylaws may permit regularly scheduled board meetings to be held with or without notice as long as the schedule of board meetings is approved at a board meeting. Board meetings may be held in or out of Washington State.

Special board meetings require that notice be sent to the directors. The procedure and timing for giving notice should be stated in the bylaws. If a director attends a meeting, the director waives the notice requirement, unless he or she attends the meeting solely to object to lack of notice. The bylaws should state whether the notice should include specific information about the business to be conducted at the special meeting.

Regular and special meetings may be conducted by conference calls or similar methods of communication that allow comment and response by all directors at the same time. If all directors sign or email a written consent to a corporate action and a record of such consents are kept in the corporate minutes book, a meeting is not required to validate the action. The Act does not currently permit "online" meetings of any kind.

f. Officers

Under the Act, the officers of a corporation consist of a president, one or more vice-presidents, a secretary, and a treasurer. The articles and bylaws may provide for the time and manner of the election or appointment of the officers; otherwise, the officers are elected or appointed annually by the board. The articles or bylaws may allow any two or more offices to be held by the same person except for the offices of president and secretary. Generally, the articles or bylaws list the specific duties and responsibilities of the officers.

Typical responsibilities of officers include the following:

- The president is responsible for facilitating the effective action of the board in governing and supporting the organization. The president sets the agenda for board meetings (in partnership with the chief executive, if one exists) and leads board meetings. Often, the president appoints the chairs of all standing and ad hoc committees of the board.

- The primary role of the vice-president is to assume the responsibilities of the president in the event of her/his absence. Often, the vice-president also carries out special assignments as requested by the president or the executive committee. If an organization has multiple vice-presidents, each is typically charged with a set of unique responsibilities.
- The secretary is responsible for maintaining corporate records. The secretary ensures that accurate meeting minutes are recorded and retained, and that notices are duly given in accordance with the provisions of the bylaws.
- The treasurer is responsible for managing the board's review of, and action related to, the organization's financial health. The treasurer ensures that comprehensive financial reports are made available to the board on a frequent basis (at least quarterly), and identifies opportunities to strengthen the board's ability to carry out its fiscal responsibilities. The treasurer is accountable for maintaining accounts and appropriate fiscal controls.

g. Minutes and Other Corporate Records

A nonprofit corporation should keep a written record of all members (if the corporation has members), board, and committee meetings. Such record is kept in the form of minutes. Minutes to a meeting should include the following:

- Identification of the group that is meeting;
- Date of the meeting;
- List of those individuals present;
- Description of items discussed and action taken on each item (including the wording of the motion or resolution adopted). If there is a conflict of interest with respect to an item, the procedure for a conflict of interest should be followed and recorded. See Chapter 8 for a discussion of a conflict of interest policy.

Optional items include a list of those absent and/or excused; a summary of the discussion that occurred with respect to each item; information regarding a vote on an item (number in favor, opposed, abstentions), identification of the individuals making and seconding motions or resolutions, and copies of motions and resolutions that failed to pass.

After the meeting, the minutes should be prepared from the notes or recordings taken at the meeting. The draft minutes are then presented at the next meeting of the group for review and approval at the meeting. Some organizations send draft minutes out to the group prior to the meeting for review. Any corrections or revisions to the minutes made by the group at the meeting should be reflected in the minutes as adopted by the group.

h. The Corporate Record Book

Each nonprofit corporation should keep a corporate record book or series of books containing all of its organizational and corporate documents. These documents include the articles and bylaws, any amendments to the articles or bylaws, minutes of all board and committee meetings, waivers of notice or notice of all meetings, tax-exemption application and determination letters, annual reports, membership certificates, all insurance policies, warranties, contracts, leases and other legal documents, and copies of all communications with board members, officers, members and contributors. Corporate records should be kept at the principal office of the corporation.

i. Public Documents

Certain corporate documents are part of the public record. In Washington, all public corporate records are kept in Olympia by the Corporations Division of the Secretary of State. The public corporate documents include the articles of incorporation and any amendments, articles of merger or consolidation, articles of dissolution, the name of the registered agent and the addresses of the registered office and registered agent, the corporate annual report forms that disclose the names and addresses of the corporation's directors and officers, and certain other information such as the Unified Business Identifier (UBI), the license expiration date, the type of corporation (nonprofit), and, with respect to corporations incorporated in other states that are qualified to do business in Washington, their states of incorporation. The annual reports filed under the Charitable Solicitations Act and the Charitable Trust Act are also part of the public record.

Chapter 33 discusses which documents are subject to disclosure under federal law for § 501(c)(3) organizations.

Chapter 12. Duties and Obligations of Board Members to the Corporation

a. Duty of Care

A director of a nonprofit corporation should take seriously the responsibility of managing the affairs of the corporation. The Act requires a director to perform his or her duties “in good faith, in a manner such director believes to be in the best interests of the corporation, and with such care, including reasonable inquiry, as an ordinarily prudent person in a like position would use under similar circumstances.”

A director must stay informed about the general affairs and finances of the corporation. Directors should examine financial statements regularly—at least quarterly—to ensure that the corporation has adequate funds to pay its debts, and that those funds are being used to further the corporation's mission and goals. An annual budget for the corporation should be approved prior to or at the beginning of each fiscal year.

The Act does not require directors to attend board meetings (though bylaws often include such a requirement). However, a director who is frequently absent from meetings will find it difficult to contribute in a meaningful way and to fulfill his or her duty of care. Organizations that are especially concerned about absenteeism can include a provision in

their bylaws specifying that a director who is absent a certain number of times shall be deemed to have resigned from the board.

Directors are expected to use common sense and practical judgment; they are not expected to be experts in every matter the board considers. In performing his or her duties, a director may rely on information, opinions, reports, or statements—including financial statements and other financial data—prepared or presented by an officer or employee of the corporation whom the director believes to be competent and reliable in the matter presented; professionals such as attorneys, accountants, or others, if the matter is within that person’s expertise; or a committee on which the director does not serve, if the matters are within the committee’s designated authority. However, if a board member has a particular expertise (e.g., accounting), he or she is expected to utilize this deeper knowledge.

Because the board is typically comprised of outsiders who do not participate in the daily management and operation of the corporation, directors often rely on staff or volunteers to provide them with information about the corporation’s operations. Directors must carefully evaluate this information to ensure that problems or potential risks or liabilities are not being withheld from or misrepresented to the board.

b. Duty of Loyalty

A director must act with the best interest of the corporation in mind, and not for his or her own personal benefit or the benefit of another person or organization. Conflicts of interest, or potential conflicts of interest, should be avoided. In the event that a conflict of interest is unavoidable, the conflict should be disclosed to the board and the director with the conflict should abstain from the discussion and the vote.

It is useful and is widely considered to be a “best practice” for a nonprofit corporation to have a written conflict of interest policy. See also Chapter 8. In addition to providing a procedure for disclosing and resolving conflicts of interest, the policy should require that each officer, director and key employee submit an annual disclosure statement specifying such individual’s (and his or her family members’):

- Business relationships with any entity that contracts with the corporation;
- Investments in companies from which the corporation obtains goods or services, to which the corporation sells goods or services, or that provides goods or services in competition with the corporation;
- Outside activities involving board, advisory board, or managerial or consulting services for any outside business, government agency, or individual that does business or competes with the corporation;
- Specific transactions with the corporation related to the sale, exchange, or lease of property; lending of money or other extension of credit; furnishing of goods, services, or facilities; payment of compensation, or payment/reimbursement of expenses in excess of \$1,000; and the transfer of income or assets; and

- Other activities that might be regarded as a potential or actual conflict of interest in connection with his or her position with the corporation.

Directors are prohibited from entering into any transaction that involves the flow or transfer of income or assets through or away from the corporation for the benefit of anyone associated with the corporation. Additionally, the Act prohibits the corporation from lending money or extending credit to any of its directors. Any director engaging in such a transaction and any director participating in the making of such a loan or extension of credit is liable to the corporation for the amount of the loan until it is paid.

Confidential matters of the corporation should be respected by all directors. Questions related to whether or not something is confidential should be discussed with the board and/or legal counsel.

c. Other Obligations

Directors must act lawfully when conducting business on behalf of the corporation. Directors must also act within the scope of authority and purpose of the corporation as specified in the corporation's governing documents. Finally, directors should ensure that the corporation is in compliance with laws and other regulations.

A board of directors functions as a group. A director cannot speak on behalf of the board or act for the board outside a meeting, unless authorized by the board as a whole. Any director attempting to act on behalf of the board without explicit authorization is exceeding his or her authority. However, officers and some committee chairs may have implicit authority to perform certain routine tasks associated with their jobs.

d. Models of Governance

In an effort to clarify the roles and responsibilities of nonprofit boards, several organizations and academic researchers have developed "models of governance" for nonprofit corporations. Most of these models go beyond simply restating the legal duties of boards and directors, aiming to set forth critical functions and processes of nonprofit boards.

One widely used model is The CompassPoint Board Model for Governance and Support (CompassPoint, 2003, <http://www.compasspoint.org>). As the name implies, the CompassPoint Model suggests that boards and directors fulfill two roles: governance and support. The objective of governance functions is to represent the community's interest within the organization, asking, "Is our organization using public and private resources to benefit the community?" The objective of support functions is to represent the organization's interest in the community, posing the question, "How can I, as a member of the board, best represent the organization in the community?"

The entire board acts as a unit when fulfilling governance functions. Board members generally act individually or through committees when fulfilling support functions.

Governance responsibilities include the following:

- *Direction*—determine mission/purpose and vision
- *Legal Affairs*—ensure compliance with laws and regulations and fulfillment of contractual obligations; manage risk; obtain adequate insurance coverage
- *Finances*—approve annual budget; review financial statements; safeguard assets from waste and misuse; review audit (if applicable); manage investments (if applicable)
- *Human Resources*—hire/fire, support, evaluate, and set compensation for the executive director; ensure that the organization has appropriate personnel policies
- *Fundraising*—approve fundraising strategy and monitor progress
- *Planning*—determine overall priorities/objectives (and related strategies)
- *Programs*—approve new programs; support the use of program evaluation to measure impact
- *Impact/Efficiency*—maximize the use of resources

Support responsibilities include the following:

- *Fundraising*—contribute to the organization’s resource development efforts (e.g., make a contribution according to one’s own means; plan and volunteer at fundraising events; solicit cash and noncash contributions; share contacts)
- *Public Relations*—act as an ambassador on behalf of the organization and its clients/customers
- *Volunteerism*—recruit and encourage volunteers (including new board members)
- *Advice*—serve as a sounding board; advise staff in areas of expertise
- *Reputation*—lend name and personal credibility to the organization for use in brochures, grant proposals, and the like

It is important to note that, when fulfilling support functions, directors will typically be taking direction from staff. Board members should be cognizant of this important distinction.

Various factors—organizational culture, size of the corporation and board, stage of organizational growth, financial resources (and constraints), and many others—will dictate the amount of time that directors will spend on governance versus support functions.

e. Board Member Job Description

Clarifying expectations for individual board members is critical, especially in relation to both time and financial commitments. Many organizations have found it useful to create a “job description” or “contract” for directors. Examples can be obtained from a number of organizations, including BoardSource (<http://www.boardsource.org>) and CompassPoint (<http://www.compasspoint.org>).

Directors are not usually compensated for their board service. However, some organizations provide reimbursement of expenses incurred during the performance of board duties, including attendance at board-authorized meetings and conferences.

Chapter 13. The Role of the Executive Director

a. Typical Responsibilities

The executive director (or chief executive officer) reports to the board of directors and is responsible for the overall management of the organization. The executive director should receive a formal evaluation from the board on an annual basis.

Working in collaboration with the board, the executive director assumes responsibility for overall organizational leadership, visioning, and long-range planning, as well as board development.

Depending on the size and structure of the organization, the executive director either assumes direct responsibility for or oversees the following:

- Financial management, including budgeting, financial forecasting, and fiscal oversight;
- Fundraising and resource development;
- Program development, implementation, and evaluation;
- Community relations, including outreach, marketing, communications, and advocacy;
- Human resources management, including the development of sound personnel policies and practices;
- Staff and volunteer recruitment, selection, evaluation, and development; and
- Compliance with federal, state, and local regulations.

Compensation among executive directors varies considerably—based on budget size, number of staff, interest area, cost of living, and a host of other factors. One source for salary data is the *Nonprofit Wage and Benefit Survey of King, Pierce, and Snohomish County*, published every two years by United Way of King County (<http://www.uwkc.org>).

b. Words of Wisdom for New Executive Directors

In “The Nonprofit ED’s First 100 Days,” *The Nonprofit Quarterly* offers advice and guidance for new executive directors. In general, the authors suggest that these critical days should be focused on gathering information, expressing curiosity and interest about the details of the work of new colleagues, and preparing to lead the organization toward the future in light of the goals and commitments expressed during the hiring process.

The article proposes “Eleven Questions for a New Leader.” They are:

1. How should I sequence these first 100 days?
2. Am I confident that I understand the organization’s current situation?
3. What are this organization’s top three opportunities and challenges? To what extent is there agreement, dissent, or indecision about priorities?
4. Which relationships are most critical for me to sustain? Who would expect to hear from me early in my tenure?
5. How should I allocate my time among internal and external relationships? How do others view this distribution?
6. What information and sources of information do I need to master to understand the field and environment of this organization?
7. Does my newness open avenues for changed relationships, new support, or repaired bridges?
8. What symbolic moves could I take to denote a new era?
9. Who else applied for this position whom I should now call on?
10. What might I later regret that I didn’t do early on?
11. What weaknesses in my own personality or style do I need to compensate for?

Oliver Tessier & Ruth McCambridge, *The Nonprofit ED’s First 100 Days*, *Nonprofit Q.*, Spring 2008, at 38-43.

c. The Executive Director/Board Partnership

An effective partnership between the board and the executive director can, among other things, enhance the prospects of success for the executive director and increase levels of satisfaction and retention among board members.

Some of the most common suggestions for enhancing this partnership include:

- Take time to establish relationships (and renegotiate “ground rules”) with each change in board president or executive director;
- Clarify and respect roles;
- Minimize surprises;

- Communicate regularly between board meetings;
- Work together to develop board meeting agendas;
- Collaborate on board orientation, training, evaluation, and leadership development; and
- Show appreciation for one another's contributions to the organization.

d. Serving on the Board

When the executive director serves on the board, it is typically in a nonvoting role. If the executive director has a voting position on the board, he or she will need to abstain on all matters related to the board's personnel functions (e.g., setting the compensation for the executive director) as well as other matters where a potential conflict of interest may exist.

Regardless of whether the executive director serves on the board, he or she should help set agendas for board meetings, and attend and actively participate in these meetings.

Chapter 14. Board Development

a. Recruitment of Directors

Every nonprofit desires and deserves a committed, knowledgeable, and effective board of directors. A nonprofit corporation should choose its directors carefully, in light of the needs of the corporation as well as the talents and characteristics of current and prospective board members. Areas to consider include:

- *Personal qualities* such as enthusiasm, creativity, passion for the cause(s) of the organization, and interpersonal skills;
- *Skills and knowledge* in areas such as marketing, evaluation, human resources, legal affairs, finance, fundraising, management, leadership, and the organization's service area(s); and
- *Demographics* such as age, gender, and race/ethnicity.

It is also important to ensure that the board is exposed to the perspectives of those being served by the organization. To this end, some nonprofit organizations make an effort to recruit former clients or customers to serve on the board (it is generally not advisable to have current clients serving on the board). Other options include establishing a "client advisory board" or developing a system for gathering input from clients on a regular basis.

b. Orientation and Training

The foundation of an effective board of directors is orientation and education. A board orientation program should be provided for all new board members, and the orientation should include time for socializing and relationship building. Potential topics for an orientation program include:

- Organizational history;
- Vision, mission, values;
- Current programs;
- Organizational priorities and significant issues/challenges;
- Budget, including an overview of major sources of funding;
- Expectations of board members;
- Parliamentary procedure (if followed); and
- An overview of board manual contents.

All directors should receive a board manual, and the contents of the manual should be updated on a regular basis. The board manual is typically developed by staff in consultation with board officers or the board development committee. For new board members, the manual serves as an orientation handbook that provides useful information about the organization. For the remainder of a director's term, the manual becomes a central resource about the organization and the activities of the board. Contents may include:

- Vision, mission, and values statements;
- Brief written history of the organization and/or an organizational fact sheet;
- Brochures, newsletters, or other publications;
- Articles of incorporation, bylaws, and IRS determination letter;
- Key policies (e.g., conflict of interest, investment, travel/meeting expense reimbursement);
- Most recent annual report;
- Most recent audited financial statements and form 990;
- Current strategic plan and/or other long-range planning documents;
- Current annual budget;
- Board meeting minutes;
- Written expectations/responsibilities of board members (both individually and collectively);
- Committee descriptions;

- Directors' and officers' insurance coverage summary;
- List of current directors and officers (with titles and affiliations and contact information);
- Brief biographies of the ED/CEO and other management staff; and
- Organizational chart.

Nonprofit organizations should make a commitment to the on-going education of board members. Training can be offered to the board as a whole (e.g., as part of an annual board retreat) or individual board members can be given the opportunity to attend conferences and trainings in the community. Common training topics for board members include:

- Financial management (understanding financial statements);
- Board roles and responsibilities;
- Cultural competency;
- Parliamentary procedure (if applicable);
- Fundraising (especially individual donor cultivation); and
- Strategic thinking and planning.

c. Evaluation

Boards have a responsibility to assess the effectiveness of both individual directors and the board as a whole. This is commonly handled through an annual board self-evaluation process. Areas to review include board composition, board recruitment, committee structure, meetings, decision-making processes, relationships with staff and other key stakeholders, and overall strengths and weaknesses.

Chapter 15. Annual Reporting Requirements

Each year, the Washington Secretary of State sends an annual corporate report form to every Washington nonprofit corporation. The corporation must return the report with the required fee to the Secretary of State by the due date to preserve its corporate status. Generally, the Secretary of State sends the report to the corporation's registered office at least 30 days prior to the required filing date. The report requests a list of the corporation's officers and directors, any change to the address of the corporation's registered office or agent and other basic information. A corporation's failure to file the report within the required time period results in automatic dissolution of the corporation by the Secretary of State. A nonprofit corporation may also be required to file annual reports pursuant to the Charitable Trust Act (see Chapter 16) or the Charitable Solicitations Act (see Chapter 43).

Finally, the corporation may be required by federal tax law to file a Form 990. See Chapter 32 for a discussion of this form.

Chapter 16. Entities to Report as Charitable Trusts

The Charitable Trust Act (“CTA”), codified in Chapter 11.110 RCW, applies to all entities, including corporations that meet the definition of a “trustee.” A nonprofit corporation meets this definition if it is either (1) formed for the administration of a charitable trust or (2) holds assets that can only be used for charitable, religious, eleemosynary, benevolent, educational or similar purposes.

a. Significance of the CTA

(i) Attorney General Enforcement Powers

The CTA empowers the attorney general to enforce the terms of the trust as the statutory representative of its public beneficiaries. Trustees are required to give the attorney general notice of all judicial proceedings affecting the trust or its administration in which the attorney general is a necessary party. The attorney general is authorized to investigate transactions and relationships involving the trust. This includes the authority to issue administrative orders requiring any person to appear to answer questions regarding trust administration.

(ii) Registration Requirement

Perhaps of greater day-to-day importance, some trustees are also required to register and report annually to the Secretary of State concerning the trustees’ affairs. While the law defines “trustee” for purposes of the attorney general enforcement powers very broadly, it requires only some trustees to register with the Secretary. The registration requirement applies when:

- The trustee holds assets that are invested for income-producing purposes. Even though assets are invested, all or part of the principal or income of the trust must be presently available for charitable purposes. A trustee is **not** required to register if the trust’s terms require that the assets be entirely expended for a charitable purpose within one year; and
- The assets have a value of at least \$250,000.

b. How to Register and Report Under the CTA

To register under the CTA, the trustee must file with the Secretary of State a copy of the instrument establishing the trust, an inventory of assets, and a registration form provided by the Secretary.

The annual reporting requirement is satisfied by filing with the Secretary a copy of the corporation’s publicly available United States tax or information return, such as a Form 990 or 990 PF. A corporation that is not required to file either of these returns can instead file a separate form provided by the Secretary, describing the corporation’s financial affairs.

Chapter 17. Amending Governing Documents

a. Generally

It is generally advisable for the board of directors of a nonprofit corporation to review its articles of incorporation and bylaws on a regular basis to ensure that the provisions in these documents are still accurate and not out of date. For example, the board will want to confirm that all of the activities conducted by the organization fall within the organization's purposes set forth in the articles. The procedures set forth in the bylaws should be confirmed as current practices of the organization.

b. Amending Articles; Restatement

A nonprofit corporation may need to amend its articles of incorporation at some time after its formation. The most common reasons for an amendment to the articles include (a) a change of name, (b) addition of or a revision to one or more of its purposes, or (c) addition of one or more of the provisions required by federal tax law to satisfy the organizational test necessary to qualify as a 501(c)(3) organization. See Chapter 21 for a description of the requirements of the organizational test.

The Washington Nonprofit Corporation Act sets forth the statutory procedure for amending articles of incorporation. In addition, the corporation's bylaws and articles should be checked for any additional requirements, such as more stringent notice or additional approval requirements. A document containing the revised or additional language, called "Articles of Amendment" must be drafted. A form for Articles of Amendment can be found online at <http://www.waaco.org>. The procedure for a nonprofit corporation to adopt the Articles of Amendment differs for corporations with voting members and corporations with no members or no voting members:

- For corporations with voting members, the board of directors first passes a resolution approving the proposed Articles of Amendment and directing a vote of the members. The board may also need to call a special meeting of the members for the vote. The members of the corporation then vote on the proposed Articles of Amendment at a regular or special membership meeting duly called in accordance with the bylaws or by mail-in or electronic ballot if permitted in the bylaws. The proposed Articles of Amendment must receive a vote of two-thirds of the members present at a meeting in which there is a quorum of members.
- For corporations with no members or no voting members, the board approves the proposed Articles of Amendment at a regular or special meeting of the board held in accordance with the bylaws. The vote to approve the Articles of Amendment must be by a majority of directors in office at a meeting in which a quorum is present. Such vote can also be held by unanimous consent resolution.

After receiving the required corporate approval, the Articles of Amendment, signed by an officer of the corporation, are filed with the Secretary of State with the appropriate

filing fee. A closing paragraph of the Articles of Amendment recites the corporate approval obtained, including the date such approval was received. The Secretary of State’s website contains a helpful form reciting the required information. The Articles of Amendment become effective on the date of filing with the Secretary of State or on such later date as stated in the Articles of Amendment.

If a corporation has amended its articles of incorporation several times or has significantly revised the articles, it may prepare and file restated articles, which integrate all of the amendments into a single document. The restated articles must be approved using the process described above and filed with the Secretary of State with the appropriate filing fee.

c. Bylaws

Nonprofit corporations amend their bylaws more frequently than they amend their articles of incorporation. The bylaws are amended in accordance with the procedure set forth in the bylaws themselves or in the articles of incorporation. If there is a procedure for amending the bylaws in both the articles and the bylaws, the procedure in the articles must be followed. Generally, amendments to the bylaws are effective with board approval alone. However, it is common for nonprofit corporations with voting members to require approval of bylaw amendments by the members. Even if a membership vote is not required, it is not unusual for the procedure for amending bylaws to call for a supermajority vote of the board or for special notice or meeting requirements. In addition to amending the bylaws, the board may also repeal one or more of the bylaws or adopt new bylaws. Once adopted, the bylaws continue to govern the affairs of the corporation until the bylaws are either amended or repealed.

Chapter 18. Sarbanes-Oxley, Document Retention, Financial Controls, Whistleblowers, and Audits

With passage of the Public Company Accounting Reform and Investor Protection Act of 2002 (often referred to by the names of its principal sponsors as “Sarbanes-Oxley,” or “SOX” for short), corporate America was prompted to give more attention to governance and financial accountability. Though SOX focuses primarily on the financial affairs of publicly traded corporations, its requirements have come to be seen by many as setting standards that should be followed by a much broader range of organizations, including nonprofits—which are usually organized as corporations.

a. What Does Sarbanes-Oxley Require of Nonprofits?

Two of the provisions of Sarbanes-Oxley have very broad application and do in fact directly pertain to the operations of most nonprofit corporations.

Title VIII extends criminal penalties to anyone who “knowingly alters . . . any record . . . with the intent to . . . obstruct . . . the investigation or proper administration of any matter within the jurisdiction of any department or agency of the United States.” (sec. 802). Destroying or altering documents related to an IRS investigation of the accuracy of a nonprofit corporation’s Form 990 (see Chapter 32 for a description of the requirements for filing a annual Form 990) is an example of the kind of misbehavior this section is designed to

punish. Having policies in place that guard against violating this section would be a good idea for any tax-exempt organization that files Form 990s.

Every nonprofit organization should take care to preserve the documentation used to prepare any reports filed with the federal government, and in particular to make clear to all volunteers and employees that no documents should be destroyed or altered if any sort of investigation of the organization's affairs is on the horizon or underway.

Title XI of SOX establishes penalties for anyone who “knowingly, with the intent to retaliate, takes any action harmful to any person . . . for providing to a law enforcement officer any truthful information relating to the commission or possible commission of any Federal offense” (sec. 1107). Of course, situations in which this provision of the law might be important to a nonprofit organization are pretty rare. Still, policies and procedures that can effectively protect whistleblowers and prevent any sort of retaliation are a good idea in general and have the added benefit of guarding against violating this section of the Sarbanes-Oxley law.

b. Financial Controls

According to an analysis of the reports of the Association of Certified Fraud Examiners (*see* Janet Greenlee et al., *How to Steal from a Nonprofit: Who Does It and How to Prevent It*, Nonprofit Q., Winter 2007, <http://www.nonprofitquarterly.org/content/view/164/1/>), the largest number of financial losses incurred by nonprofits in the study sample were cases where a long-term, trusted employee systematically stole small amounts of money in ways that could add up to substantial losses. While, every organization can experience such losses, understaffed nonprofits with highly committed volunteers may be especially vulnerable. The best defense is to develop and enforce policies and procedures—often called financial controls—that make everyday forms of fraud more difficult. There are websites and handbooks that offer examples of appropriate financial controls adapted to different situations. For example, COSO.org urges that organizations look at five elements of internal control to evaluate effectiveness: (1) the public commitment to control from the leaders of the organization, (2) the assessment of the organization's financial risks, (3) reviews of the internal control system, (4) communication with the audit committee and throughout the organization, and (5) regular monitoring of controls (*see* “Does Your Control System Pass the COSO Test” at <http://www.theiia.org/download.cfm?file=57080>). Bookkeepers and certified public accountants can also provide advice tuned to the daily operations of various sorts of nonprofits.

c. Whistleblower Policies

An effective and widely publicized whistleblower process will give a backbone to financial controls. Reports from others connected to the organization were the source of 43% of the reports of fraud in the study mentioned above: half of these came from employees of the organization. Thus a whistleblower policy can be an important deterrent and safeguard to make it easy for clients, volunteers, employees and vendors to bring attention to suspicious behavior in ways that avoid embarrassment and the risk of retaliation. There are firms that will set up confidential reporting systems using toll-free telephone numbers at low cost. It is also possible to ask credible volunteers to act as confidential recipients of tips and reports if

appropriate procedures can be put in place so the volunteers have a clear path of action should a report be made. Simple fairness, as well as compliance with Sarbanes-Oxley, requires assurances that making a report in good faith, even if it turns out to be a mistake, should not expose the person making the report to any risk of adverse consequences.

d. Audits and an Independent Audit Committee

The sections of Sarbanes-Oxley that focus on audits do not directly apply to nonprofits. They are based, though, on sound principles for the design and execution of an audit program for any nonprofit organization that needs to have one. Some grantmakers and some state and local regulators require audits in certain circumstances; other organizations may have an audit performed to satisfy management as well as donors and other key stakeholders that financial information can be relied on for decision-making and planning.

Audits and Charitable Solicitations

The Washington Charitable Solicitations Act (Chapter 19.09 RCW) requires all organizations that solicit contributions from the public for charitable purposes to register and report on their activities annually to the Charities Program in the Office of the Secretary of State. An organization that receives more than an average of \$3 million in gross revenue (from all sources) over three years is required to provide audited financial statements with its next annual report; an organization that receives more than an average of \$1 million in gross revenue over three years is required to submit its annual governmental financial report (usually, Form 990) and to have it reviewed or prepared by an experienced preparer with its next report to the Charities Program. (Washington's charitable solicitations law can be accessed online at <http://apps.leg.wa.gov/RCW/default.aspx?cite=19.09&full=true>.) See Chapter 43.

The core principles on which the SOX requirements are based are easy to understand: first, the audit process for the organization should be set up to ensure that the board of directors has full access to the auditor's recommendations and report, and second, the board should make sure that the auditor's report is reviewed by people who are savvy about financial questions and the audit process itself. The American Institute of Certified Public Accountants ("AICPA") offers an audit committee toolkit that can help a nonprofit organization prepare for and use an audit well. See <http://www.aicpa.org/Audcommctr/toolkitsnpo/>.

It is important to note that the purpose of the audit is to provide a professional opinion that the financial statements "present fairly, in all material respects, the financial position and changes in net assets and cash flows in conformity with generally accepted accounting principles." ("Generally Accepted Accounting Principles," or "GAAP," are developed and published by the Financial Accounting Standards Board.) This assessment is important to anyone who might make a loan or a grant to the organization. An organization that has concealed significant financial weaknesses by "cooking its books" is a good candidate for disappointments, or worse. Recent new standards for audits from AICPA require auditors to document their understanding of the organization's internal controls, assess the risk that the financial statements might be affected and plan the audit to address those risks. Because of these new risk-assessment standards, it is likely that audit communications will contain more frequent statements about weaknesses in an organization's internal control for audits done for fiscal years after 2006.

Though weaknesses identified following these new audit standards might well point to areas of concern from the point of view of fraud or abuse of other sorts, financial audits

are not done in a way that is designed to expose employee misconduct or theft. Only a specialized, “forensic,” audit is designed with the goal of discovering those sorts of activities if they are occurring. There are specialists that concentrate on doing this sort of work—when necessary—using different techniques and observing different standards (members of the Association of Certified Fraud Examiners are an example).

e. Conclusion

Donors, and the general public, are quite reasonably concerned that nonprofit organizations handle their assets with care and use them wisely. The topics discussed in this chapter provide an outline of several of the policies and practices that are routinely used by nonprofits as a foundation for building a culture of good governance and financial responsibility. Nonetheless, there is much more to creating and maintaining a climate in which financial irresponsibility or misdeeds will be simply unthinkable for everyone engaged in an organization. That is the goal to which every nonprofit must aspire.

Chapter 19. Exposure and Risks of Directors and Officers

a. Directors’ and Officers’ Liability and Exposure

A director or officer is not automatically liable simply because the corporation is sued. Rather, liability arises because the director or officer is charged with some breach of a duty owed either to the corporation or to a specific party. Suits against directors or officers typically are brought in one of three ways:

- An outside party may sue a director or officer directly, claiming some injury by the corporation.
- A party may assert some right of the corporation against a director or officer, suing to enforce the right of the corporation. This type of suit is referred to as a “derivative action.” In effect, the corporation is suing the director or officer to enforce the corporation’s rights, typically because of an alleged breach of the director’s or officer’s duty of care or duty of loyalty to the corporation.
- A director or officer may be held independently liable under various statutory provisions concerning issues such as employment practice claims, environmental claims, tax delinquencies or antitrust claims.

Another source of possible liability arises in the context of corporate loans. Washington law prohibits nonprofit corporations from making loans to directors or officers. Any director who votes for or assents to such a loan and any officer who participates in making such a loan will be jointly and severally liable to the corporation for the loan amount until the loan is repaid.

b. Indemnification

Directors and officers of a nonprofit corporation typically will want the corporation to have a program of indemnification to the maximum extent permitted by applicable law. In Washington, a nonprofit corporation may indemnify its officers and directors to the same extent that a for-profit corporation can.

A corporation may indemnify its directors and officers whether or not they successfully defend against a suit, so long as the director or officer acted in good faith and reasonably believed that actions taken on behalf of the corporation were in the corporation's best interests, and that any other actions (i.e., actions taken in their individual capacities) were not opposed to the corporation's interests.

In a criminal proceeding, indemnification is allowed only if the director or officer had no reasonable cause to believe the conduct was illegal. A corporation may not indemnify a director or officer if the director or officer is found to be liable to the corporation or if the director or officer received an improper personal benefit.

A nonprofit corporation may pay for or reimburse the reasonable expenses incurred by a director or officer who is a party to a proceeding in advance of the final settlement of the proceeding if the director or officer states in writing that he or she acted in good faith and reasonably believed that his or her conduct was in the corporation's best interests and the director or officer states in writing that he or she will repay the advance if it ultimately is determined that the standard of conduct described above was not met.

The corporation must authorize an advance of expenses by a provision in its articles of incorporation or bylaws or by resolution adopted by the board of directors.

If a corporation indemnifies or pays the expenses of a director's or officer's defense against liability, the corporation must provide a written report to its members (if any) before the next members' meeting (note: this provision only applies if a corporation has "members").

c. Statutory Protections

A corporation's articles of incorporation or bylaws may contain certain provisions that eliminate or limit the personal liability of a director to the corporation. Such provisions, however, may not eliminate or limit the liability of a director for acts or omissions that involve:

- Intentional misconduct by a director;
- A knowing violation of law by a director; or
- Any transaction from which the director will personally receive a benefit in money, property or services to which the director is not legally entitled.

Limiting a director's personal liability is discretionary on the part of the corporation, and may be incorporated into an organization's articles. There is no similar provision for officers.

Both officers and directors of nonprofit corporations are afforded some protection against personal liability to third parties under Washington's special immunities law. A director or officer of a nonprofit corporation is not individually liable for any discretionary

decision or failure to make a discretionary decision within his or her official capacity as a director or officer unless the decision or failure to decide constitutes gross negligence.

A federal statute entitled the Volunteer Protection Act of 1997 (the “Volunteer Act”) may also provide some protection to directors and officers of nonprofit corporations. This statute, which took effect in September 1997, provides immunity from personal liability to volunteers, including unpaid directors and officers, working for nonprofit corporations for acts or omissions within the scope of their assigned responsibilities. To qualify for protection under the Volunteer Act, certain criteria must be met:

- A person seeking protection under the Volunteer Act must be a “volunteer.” The Volunteer Act defines a volunteer as a person who provides services to a nonprofit organization but does not receive compensation or any thing of value in excess of \$500 per year for his or her services. Thus, if a nonprofit corporation’s directors or officers receive compensation for their services, the Volunteer Act’s protection will not apply. A director or officer may, however, receive reimbursement of his or her expenses.
- The volunteer must have been acting within the scope of his or her responsibilities for the organization at the time the harm took place. In other words, the officer or director must have been acting in his or her capacity as an officer or director of the corporation, rather than in some other capacity, such as volunteering at a fundraising event.
- The officer or director must show that the harm in question was not caused by his or her willful or criminal misconduct, gross negligence, reckless misconduct or a conscious, flagrant indifference to the rights or safety of others. Although these terms are all legal terms with specific meanings under Washington law, generally, merely being careless or inattentive is not considered willful, gross or reckless conduct.

There are several important things that the Volunteer Act does not do. Perhaps most importantly, the Volunteer Act does not prevent individuals acting as volunteers from being sued or being named in a lawsuit. Instead, the Volunteer Act provides an affirmative defense to liability, which lawyers for the volunteer would raise in the course of the litigation. Although a volunteer might be named as a defendant in the initial stages of the case, it is very likely that the claims would be dismissed early in the process, assuming all the criteria of the Volunteer Act are satisfied.

The Volunteer Act does not protect the nonprofit organization itself from liability for harms suffered in the course of its activities. The organization may be held responsible for the acts or omissions of the persons working for it, even if the persons cannot be held individually liable. Finally, the Volunteer Act does not prevent nonprofit organizations from suing their volunteers for misconduct. Thus, if an officer or director harms the organization in some way, the organization still can bring suit against such officer or director without the protection provided by the Volunteer Act being invoked.

Chapter 20. Directors' and Officers' Insurance

A nonprofit corporation may purchase liability insurance on behalf of its directors and officers to cover certain claims. A directors' and officers' insurance policy ("D&O insurance") will generally provide coverage for liability claims against a director or officer whether or not the corporation indemnifies that individual. Directors and officers will often want the corporation to provide D&O insurance even if the corporation's articles of incorporation or bylaws have generous indemnification provisions.

D&O insurance provides three types of coverage: (1) coverage for the corporation's directors and officers when the corporation does not indemnify them; (2) coverage for the corporation for amounts the corporation actually pays directors and officers for indemnification; and (3) coverage for claims brought against the corporation. D&O insurance policies usually cover defense costs as well as liabilities arising from individual officers or directors allegedly committing "wrongful acts," which will be defined in the policy. Most D&O insurance policies exclude claims based on:

- Dishonest, fraudulent, or criminal acts. Even if the policy does not specifically exclude coverage for claims based on such conduct, most definitions of "wrongful act" specifically include only negligent conduct;
- Fines, penalties or punitive damages;
- Intentional conduct such as libel and slander—as a general rule, insurance does not cover intentional conduct;
- Bodily injury or property damage;
- A director or officer gaining any personal profit or advantage to which he or she was not legally entitled;
- ERISA claims;
- Employment claims;
- Claims brought by the corporation against its own directors or officers; or
- Losses covered by other insurance.

D&O insurance policies are generally claims-made policies. That is, a claim must be both made and reported during the policy period for there to be coverage. Therefore, it is extremely important to notify the carrier the moment the corporation or its directors or officers recognize that a claim may be made. D&O insurance policies may give the insurer the right to choose defense counsel, or, more often, may limit the policyholders' choice of counsel. D&O insurance policies generally require the policyholder to notify the carrier of all settlement offers and obtain its consent before accepting them. It is very important to recognize that, while D&O insurance policies generally require a carrier to pay ongoing

defense costs, such payment can be charged against the policy's liability limit, reducing the amount available for payment of a judgment or settlement.

The elements of D&O insurance such as deductibles, co-insurance levels, exclusions and other aspects can vary significantly. The board committee dealing with insurance issues should review such items carefully and should consider consulting an insurance broker knowledgeable in this field. Except for exclusions for intentional conduct, other exclusions and coverage features can often be changed through negotiation with the carrier and/or payment of additional premium.

PART IV. OBTAINING RECOGNITION AS A 501(c)(3) ORGANIZATION

Chapter 21. Considerations in Determining Whether (and When) to Seek 501(c)(3) Status

The initial steps in the process of obtaining recognition as a 501(c)(3) organization exempt from federal income taxes are (1) forming a nonprofit corporation or other suitable nonprofit entity under the law of a state and then (2) completing and filing IRS Form 1023. This Part describes the preparation of Form 1023.

Federal tax-exempt status under Code § 501(c)(3) provides advantages including (1) tax benefits for some contributors to the organizations, (2) eligibility for private foundation grants, and (3) an exemption from the federal corporate income tax on most net income. However, to obtain this tax-exempt status, an organization must operate in compliance with certain restrictions: (1) its purpose must be charitable, (2) it cannot provide financial benefits to private individuals, (3) it cannot promote or oppose candidates for public office, and (4) its lobbying activities are restricted. Before deciding to proceed with an application for 501(c)(3) status, it is worth considering whether the advantages of this status are important to achieving the organization's goals and whether the restrictions would materially impair the organization's ability to accomplish these goals. Also, it is worth considering whether the organization will meet the criteria necessary to qualify as a public charity and, if not, what the effect would be of needing to comply with the more restrictive rules applicable to private foundations.

a. Why Seek 501(c)(3) Status

501(c)(3) organizations enjoy a variety of tax-related and other benefits.

(i) Individual and Gift and Estate Tax Deduction

One of the biggest advantages of being a 501(c)(3) organization is that the organization may receive contributions that also benefit the donor—in fact, 501(c)(3) organizations are the only organizations to which people can make tax-deductible charitable contributions. A donor who contributes may be entitled to an income tax deduction, a gift and estate tax deduction or both. Donors are subject to limitations on the deductions they can claim for charitable contributions in any given year. Donors should consult their own tax advisors regarding the tax implications of gifts to your organization.

(ii) Grants From Private Foundations

Private foundations, which often are grantmaking organizations, typically will distribute funds only to 501(c)(3) tax-exempt organizations that qualify as “public charities.” (Private foundation status and public charity status are discussed below.) It is worth noting that private foundations are, in fact, permitted to make grants to any type of entity, provided that such grants are made in furtherance of the foundation's 501(c)(3) purposes and provided that the foundation complies with certain administrative requirements under § 4945 of the Code; however, because these administrative requirements can be burdensome, many foundations choose to make grants only to 501(c)(3) public charities.

(iii) No Tax on Net Revenue

A big advantage shared by 501(c)(3) organizations and the organizations described under other 501(c) categories is that such organizations generally are exempt from paying federal income tax on income related to their tax-exempt function and often on investment income as well.

(iv) Other Advantages

Some other advantages are:

- Federal tax-exempt status is necessary for certain state and local tax benefits (e.g., exemptions from property tax, B&O tax and admissions taxes, as further discussed in Chapters 48-54).
- 501(c)(3) organizations are exempt from federal unemployment tax (“FUTA”).
- Exempt organizations may qualify for bulk mailing rates.
- 501(c)(3) organizations may be permitted to engage in bingo or other gaming activities that otherwise would be prohibited.

b. Requirements and Limitations on 501(c)(3) Organizations

Organizations that obtain 501(c)(3) tax-exempt status must operate in accordance with specific rules applicable to 501(c)(3) organizations.

(i) Permissible Purposes

In order to gain recognition as an organization described in § 501(c)(3) of the Code, an organization must be organized and operated exclusively for one or more of the purposes specified in § 501(c)(3) (e.g., charitable, educational, religious, literary or scientific purposes, fostering national or international amateur sports competition, testing for public safety or prevention of cruelty to animals). In addition, a 501(c)(3) organization must serve public rather than private interests. Generally, this means that its activities benefit a large and indefinite class of individuals (e.g., the general public, homeless people, youth), rather than a small identifiable group (e.g., the organization’s members, residents of a single neighborhood, employees of a small company). The organization may not be organized or operated for impermissible private interests such as those of specifically designated individuals, the creator of the organization or his/her family, or persons (including companies) controlled, directly or indirectly, by such private interests.

The applicable Treasury Regulations provide that “charitable” includes “relief of the poor and distressed or of the underprivileged; advancement of religion; advancement of education or science; erection or maintenance of public buildings, monuments, or works; lessening the burdens of government; and the promotion of social welfare by organizations designed to accomplish any of the above purposes.” *See* Treas. Reg. § 1.501(c)(3)-1(d)(2). Some of these purposes are described in more detail below; however, a comprehensive

discussion of permitted 501(c)(3) purposes is beyond the scope of this Chapter. A more detailed discussion of permissible 501(c)(3) activities is included in Chapter 3 of IRS Publication 557, available at <http://www.irs.gov>.

Descriptions of Common Categories of Charitable Purposes

Relief for the poor and distressed or the underprivileged includes:

- a. helping low-income persons find employment;
- b. promoting the rights of public housing tenants; or
- c. providing other social services like low-income housing, food, or health services.

Advancement of religion includes:

- a. constructing or maintaining a church building, monument or burial grounds, or
- b. peripheral services like providing music, distributing religious literature and maintaining missions.

Advancement of education includes the instruction or training of the individual for the purpose of improving or developing his or her capabilities and/or the instruction of the public on subjects useful to the individual and beneficial to the community. Educational organizations might:

- a. operate a primary or secondary school, a college, or a professional or trade school that has a regularly scheduled curriculum, a regular faculty, and a regularly enrolled body of students in attendance at a place where the educational activities are regularly carried on;
- b. present public discussion groups, forums, panels, lectures, or other similar programs;
- c. operate museums, zoos, planetariums, symphony orchestras, theatres, and other similar organizations; or
- d. produce arts performances such as plays, music or dance.

Organizations formed to beautify and maintain the community may:

- a. preserve a park or lake for public use;
- b. promote city beautification projects; or
- c. educate the public about advantages of planting trees in public areas.

Examples of the promotion of health include hospitals, outpatient clinics, homes for the aged, and advancing medical knowledge through research.

For the most part, organizations engaged in promoting social welfare generally are involved in solving urban problems, easing racial tensions, furthering historic preservation, or improving the environment. Examples include organizations that:

- a. construct low-income housing and renovate existing housing for low-income persons;
- b. furnish low-interest loans to local businesses in depressed inner-city areas;
- c. convert blighted inner-city property into industrial parks and give rental preference to employers who employ otherwise unemployed individuals; or
- d. promote sports for youngsters in a community because it helps combat juvenile delinquency.

(ii) No Private Inurement

A 501(c)(3) organization may not distribute its revenue or assets to benefit any private individuals. Called “inurement,” this proscription generally applies to persons who, because of their particular relationship with an organization, have an opportunity to control or influence its activities. See Chapters 27 and 28 for a more detailed discussion on private inurement and intermediate sanctions.

(iii) Restrictions on Lobbying and Political Activities

Chapter 30 describes the rules and restrictions 501(c)(3) organizations must follow with respect to lobbying and political activities.

(iv) Limitations on Unrelated Business Activity

As further discussed in Chapter 31, an organization that engages in unrelated business activity may have some taxable income and may jeopardize its tax-exempt status if such activity is substantial relative to the organization’s tax-exempt activity.

(v) Public Disclosure Requirements

As discussed further in Chapter 33, a 501(c)(3) organization must make certain documents available for public inspection.

(vi) Nondiscrimination

Generally, an organization should not discriminate. Race discrimination is strictly prohibited. An institution that racially discriminates cannot qualify for tax-exempt status as a charitable organization. In 1993, the United States Supreme Court held in the famous case of *Bob Jones University v. United States* that private schools that racially discriminate may not be tax-exempt and are not eligible for deductible charitable contributions. The rule against racial discrimination applies to all entities seeking tax-exempt status, not just private educational institutions.

c. Public Charities and Private Foundations

501(c)(3) organizations are divided into two broad categories: private foundations and public charities. An important consideration in applying for 501(c)(3) status is determining whether the organization will qualify for one of the enumerated public charity categories. If an organization qualifies as a 501(c)(3) organization but cannot establish that it qualifies for one of the public charity categories specified under § 509(a) of the Code (and discussed further below), the organization is, by default, a private foundation. Generally, private foundations receive most of their support from one or a limited number of sources, such as a single family or corporation. Unlike public charities, they pay tax on their investment income. Also, private foundations are subject to additional rules and restrictions that do not apply to public charities.

(i) Public Charities

The various public charity categories are set forth in Code §§ 509(a)(1) through 509(a)(4). They include (a) entities that are considered inherently public by virtue of their activities (i.e., churches, schools, hospitals and medical research organizations); (b) publicly supported organizations (including both (i) organizations that normally receive a substantial part of their support from gifts, grants and contributions from the general public and (ii) organizations that normally receive more than one-third of their support from grants, contributions, membership fees, and gross receipts derived from activities related to their exempt function); (c) supporting organizations that are controlled by or in connection with one or more public charities; and (d) organizations organized and operated exclusively for testing for public safety.

Chapter 3 of IRS Publication 557 includes a detailed discussion of how private foundation status and public charity status are determined. It is worthwhile spending time with this section of Publication 557 and determining which, if any, of the public charity categories apply to your organization before you begin drafting your organization's application for 501(c)(3) status. This will help you ensure that you present information in your application that is relevant to the type of public charity or private foundation status you hope to obtain.

(ii) Disadvantages of Private Foundation Status

Federal tax law generally treats private foundations less favorably than public charities. Unlike public charities, private foundations must pay tax on their investment income, are prohibited from engaging in any lobbying activity and are subject to a variety of other highly technical and complicated requirements regarding how they invest their assets and conduct their operations. Failure to comply with these rules can result in the imposition of excise taxes on the foundation as well as on its officers, directors or trustees. If your organization is, or if you believe it may be determined to be, a private foundation, you should consult a legal professional.

The special restrictions and excise tax rules applicable to private foundations are set forth under §§ 4940 through 4944 of the Code. They include:

- **Excise Tax Based on Investments.** Section 4940 imposes a 1-2% excise tax on investment income, such as interest, stock dividends, capital gains and other passive income.
- **Taxes on Self-Dealing.** Under § 4941, transactions between a private foundation and certain organizational insiders (including foundation managers, large contributors and companies owned by large contributors) generally are prohibited unless a special exception applies.
- **Taxes on Failure to Distribute Income.** Each year a private foundation must distribute a minimum amount of its income for charitable purposes. If it does not, it will be subject to an excise tax under § 4942.

- **Taxes on Excess Business Holdings.** A private foundation may be subject to an excise tax under § 4943 if it owns more than a certain percentage of a trade or business enterprise.
- **Taxes on Investments That Jeopardize Charitable Purposes.** Under § 4944, a private foundation may be subject to an excise tax if it jeopardizes the foundation’s ability to carry out its charitable purposes by making high-risk investments. This tax provides an incentive for private foundation managers to be prudent when investing foundation funds.
- **Taxes on “Taxable Expenditures.”** Section 4945 imposes a tax on amounts spent by private foundations that are used for carrying on propaganda or otherwise attempting to influence legislation, influencing the outcome of political campaigns, and making expenditures for noncharitable purposes. Section 4945 further regulates the use of private foundation funds for certain other activities by placing certain limitations on grants to individuals for travel, study, or other similar purposes (unless the foundation follows certain procedures approved in advance by the IRS) and by taxing grants made to organizations other than public charities (unless the grantor private foundation exercises expenditure responsibility with respect to such grants).

d. When to Seek 501(c)(3) Status

New organizations normally have up to 27 months (15 months, plus an automatic 12-month extension) to submit a Form 1023 to the IRS. When a Form 1023 is filed late and no exception applies, the IRS grants 501(c)(3) status “prospectively,” that is, effective beginning with the date postmarked on the application envelope. An organization that missed the 27-month deadline can usually get 501(c)(4) status for prior periods.

The “15 Month Rule” is waived for churches, subordinate organizations covered by a group ruling, organizations created before October 9, 1969 and small publicly supported organizations. Small public charities are not officially required to file the application as long as gross receipts continue to average less than \$5,000 per year. NOTE: An organization that no longer qualifies for the low gross receipts exception must submit its application to the IRS within 90 days of the end of the year in which average gross receipts exceed \$5,000 if it wishes to obtain fully retroactive 501(c)(3) status.

e. Considerations for Organizations Not Required to File for 501(c)(3) Status

Even though churches, organizations created before October, 1969 and publicly supported organizations whose gross receipts average less than \$5,000 per year are not required to file, there are a number of reasons why such organizations might want to apply:

- Although § 508 of the Code provides deductibility of contributions for churches and small organizations, the burden of proof for tax deductibility is on the donor. A church or small organization might choose to apply for

501(c)(3) recognition to save donors possible embarrassment and inconvenience during an audit.

- Almost every grantmaking agency, public or private, requires a 501(c)(3) determination letter from grant applicants. A church or small organization might need to apply for 501(c)(3) recognition if it plans to seek grant funding.
- Other state and federal agencies, such as the Postal Service or the Washington Gambling Commission, may require proof of exempt status before issuing permits or exemptions. Each agency has its own rules, which may not provide exceptions for churches and small organizations. Such organizations might have to apply for 501(c)(3) recognition to satisfy other governmental agencies.
- Failing to apply for IRS exempt status can sometimes undermine an organization's credibility with the press or the public. A church or small organization might find that 501(c)(3) recognition is an important part of the image it wants to convey.
- An organization that expects to have employees can save a small amount of payroll taxes by applying for 501(c)(3) recognition. A 501(c)(3) letter means an organization will not have to pay FUTA.

Chapter 22. Assembling Your Application

An organization applies for 501(c)(3) status by submitting Form 1023 (Application for Recognition under Section 501(c)(3) of the Code). In addition, depending on the organization's circumstances, it may submit other IRS forms along with this application (e.g., a power of attorney, if the organization is represented by someone other than an officer in connection with filing its 501(c)(3) application and/or an election to make lobbying expenditures). Please note that all IRS forms discussed in this Chapter are available at <http://www.irs.gov> by clicking on "Forms and Publications" on the left side of the IRS home page and scrolling down until you find the appropriate Form and/or Form instructions. This Chapter describes the information you will need to complete your Form 1023, as well as the documents and other forms that you may submit with your application. In addition, it provides tips that will help you compile your application in a manner that facilitates IRS review.

a. Before Assembling Your Application: Form SS-4

An organization should use Form SS-4 (Application for Employer Identification Number) to apply for its EIN before submitting its Form 1023. The quickest and easiest way to obtain an EIN is through <http://www.irs.gov>. (Click on "Apply for an Employer Identification Number (EIN) Online" from the IRS homepage.) Alternatively, you can download the Form SS-4 from the IRS website, complete it, have it executed by an officer of the organization and then fax it to the IRS at (801) 620-7115 (not toll free). Be sure to enter a "fax-back" number on the SS-4. Once you have obtained your EIN, you will enter it on every

page of your Form 1023 (Part I, line 4 on page 1, in the upper right-hand corner of each subsequent page and on attachments).

b. Ancillary Forms: Form 5768 and Form 2848

Depending on the organization's circumstances, it may file one or both of the following forms along with its Form 1023:

(i) Form 5768 Election/Revocation of Election to Influence Legislation

This is required if the organization has decided to elect to make expenditures to influence legislation under § 501(h) of the Code. See Chapter 30 for a more detailed discussion regarding deciding whether to make this election.

(ii) Form 2848 Power of Attorney

This is required if the organization will be represented, or the various IRS forms signed, by someone other than an officer or director, such as the organization's lawyer. If you are submitting a Form 2848, be sure that the date accompanying the signature of an officer of the organization (Part I, line 9) is the same date as or an earlier date than the date accompanying the signature of the authorized representative under Part II. Also, note that the Form 1023 must be signed by an officer of the organization, regardless of whether a Form 2848, designating another individual to have power of attorney, is submitted.

c. Gathering Necessary Documents and Information

Form 1023 asks for a lot of information regarding the organization's activities and finances. While Form 1023 may at first appear daunting, it may be useful to think of this application as analogous to a business plan. Hopefully, the exercise of responding to the detailed questions posed by the application will help you establish a well-thought-out road map to guide your organization's development. Below, we describe the documents and information you may want to gather in preparation for drafting and compiling your Form 1023.

(i) Required Documents

Before drafting responses to Form 1023, it may be helpful to gather the following documents, which will be incorporated into your final submission:

- **Articles of Incorporation.** A copy of the articles of incorporation must be submitted (bylaws alone are not enough). Articles of Incorporation should have the Secretary of State's date stamp on the first page. The articles of incorporation must meet the "Organizational Test." Under the organizational test, the organization must meet two requirements: (a) first, the statement of purposes in the articles of incorporation must limit the organization's purposes to one or more tax-exempt charitable purposes and may not authorize the carrying on of any activities that in themselves are not in furtherance of one or more exempt purposes (unless they are insubstantial), and (b) second, the

organization must dedicate its assets to one or more exempt purposes. This dedication of assets to an exempt purpose occurs in the dissolution provision in the organization's articles. Such a provision may require that the organization's assets be distributed for one or more exempt purposes, be distributed to the federal government or to a state or local government for a public purpose, or be distributed by a court to another organization to be used in a manner as in the judgment of the court will best accomplish the general purposes for which the dissolved organization was organized. The sample articles of incorporation available online at <http://www.waaco.org> contain provisions for meeting the organizational test.

- **Bylaws.** The bylaws should have been adopted by the board of directors, signed by the secretary or other officer and dated.
- **Conflict of Interest Policy.** Although an organization is technically not required to have such a policy, the IRS strongly suggests that every organization adopt a conflict of interest policy, and the Instructions to Form 1023 include a sample document that can be adopted and included as part of the application. Like the bylaws, this should be adopted by the board of directors, signed by an officer and dated.

(ii) Required Information

Also, before drafting responses to the Form 1023, it may be helpful to gather the following information, which will help you answer questions posed by the Form 1023:

- **Description of Activities.** Form 1023 requires a description of the organization's past, present and planned activities. With respect to each activity, you should be prepared to describe (a) what the activity is; (b) who conducts it; (c) where it will take place; (d) when the activity is conducted; (e) how it will be funded; (f) how it furthers the organization's tax-exempt purposes; and (g) what percentage of the organization's total time is dedicated to such activity.
- **Director/Officer Resumes.** Form 1023 asks for resumes or summaries of the qualifications of the organization's officers, directors, trustees, highest compensated employees (who receive over \$50,000 per year) and highest compensated independent contractors (who receive over \$50,000 per year).
- **Financial Data.** Form 1023 requires historical and/or projected financial data. If the organization has been in existence for four or more years, it must provide information regarding its revenues and expenses regarding the past four years. If it has been in existence for more than one year, but less than four years, it must provide revenue and expense information for each year it has been in existence, plus projected revenue and expense information for a total of three years of financial information. If the organization has been in existence for less than one year, it must provide projections of its likely

revenues and expenses for the current year and the two subsequent years, based on reasonable and good faith estimates of its future finances.

(iii) Information to Include if Applicable

Form 1023 asks for a variety of other documents and information, which may or may not be applicable to your organization. After skimming the list below, it may be helpful to gather any of the following documents that are relevant to your organization and its activities:

- **Printed materials.** Printed materials describing the history of the organization, its activities and/or its plans for the future, which might include newsletters, brochures, pamphlets, descriptive literature, published materials, etc.
- **Materials Prepared for Members.** If the group is a membership organization, any materials prepared for members, such as membership application forms, promotional materials, sample membership certificates or identification cards, sample copies of member-only publications, etc.
- **Clippings.** If the organization has received media coverage, copies of newspaper clippings, transcripts of interviews, etc.
- **Events.** If appropriate, a “schedule of events,” showing where and when the organization has held informational, educational, performance or other events during the last 12 months, including approximate attendance.
- **Fundraising Activities.** Information regarding the organization’s fundraising plans, including how it plans to raise funds and in which jurisdictions it will undertake such activities.
- **Grantmaking Activities.** If the organization will be making grants to other organizations:
 - Copies of any grant agreements;
 - A description of records your organization keeps regarding its grants;
 - Information regarding your selection process, including whether a grant proposal or application is required; and
 - A description of your organization’s procedures for oversight of distributions to ensure that its resources are used for tax-exempt purposes (e.g., conducting pre-grant inquiry and/or requiring periodic or final reports regarding the use of grant funds).
- **Scholarships or Grants.** If the organization will have a scholarship or grant program:

- A description of how potential applicants will hear about the program;
- A description of eligibility requirements;
- A sample of the application form(s) applicants will be required to submit;
- A description of the selection process, including a description of any selection committee and how members of the selection committee are chosen;
- Any guidelines prepared for the selection committee's use;
- Conditions placed upon grants or scholarships, including any requirements for reports and a description of action that will be taken if the terms of the grant are violated; and
- Records the organization keeps regarding its grants or scholarships.
- **Other Materials.** If relevant, gather the following:
 - Copies of leases, loan agreements or other contracts between the organization and its officers, directors, highest compensated employees, highest compensated independent contractors or any entity in which any of the above individuals owns more than a 35% interest;
 - Independent appraisals or other data substantiating the value of any assets the organization is renting or purchasing from related parties; and
 - Copies of any agreements pursuant to which another individual or organization will raise funds for your organization or pursuant to which your organization will raise funds for any other organization.
- **Information Required for Schedules.** The Form 1023 has a number of schedules, which must be filled out if applicable to the organization. These include special schedules if the organization is a church, school, hospital or supporting organization or provides low-income housing or provides scholarships. If any of the Form 1023 schedules applies to the activities of your organization, be sure to review the applicable schedule so that you can gather all of the required information.

d. Tips for Completing Form 1023

The comments below relate to the June 2006 revision of Form 1023.

(i) General Considerations

Throughout Form 1023, if the form does not permit enough space to answer the question posed, it may be preferable to say “Please See Attachment” or “Please See Exhibit Attached” and attach a word document or spreadsheet, as necessary. Inserting these in the appropriate spot within the pages of the application itself (i.e., behind the page of the application that references the attachment) will facilitate IRS review by making it easy for the IRS agent to find your attachments. Be sure to label each attachment with the organization’s name and employer identification number and the question number to which the attachment relates.

In completing the application, it is important to be as transparent as possible regarding the organization’s activities, finances, etc. To some degree, it is more important that accurate and comprehensive information be included in the application than that the information be included in a particular place in the application. If you feel you have already provided information requested in one part of the application in response to a question elsewhere in the application, you may find it convenient to cross-reference such information rather than repeating it. For example, if an organization intends to make grants to support foreign charitable organizations, it might describe this activity in detail in its narrative description of activities under Part IV. The organization’s responses to Part VIII, questions 13 and 14, might then cross-reference “Attachment 1, responses to Part IV.”

(ii) Walk Through Form 1023

Refer to the Form 1023 instructions for guidance in completing your application. As noted above, the instructions, like Form 1023 itself, can be downloaded from <http://www.irs.gov> by clicking on “Forms and Publications.” We have not provided line-by-line instructions for completing Form 1023. Instead, we provide below tips that are intended to supplement the IRS instructions.

(a) Page 2—Part IV (Narrative)

This is the heart of the application. The narrative can literally make or break the application. One approach is to start with the formula:

[Name of organization] is organized exclusively for [religious, charitable, scientific, literary or educational (choose one or more)] purpose(s) within the meaning of § 501(c)(3) of the Code. Specifically, [Name of organization] (describe in one or two sentences what the organization does).

In succeeding paragraphs, define the problem the organization hopes to solve, using specific data or statistics if available. Try to cover WHO, WHAT, WHEN, WHERE, HOW, etc. Examples:

- Who will the organization’s members, clients or patrons be? Who will carry on the activities of the organization?

- What will the organization offer to these individuals or entities? What will the organization charge? What will take place at a typical meeting or event of the organization?
- When did the organization’s founders begin working to further the organization’s purposes? When will the organization be fully operational? When will regular meetings, events or other program activities be held?
- Where will the organization be based? Where will the organization obtain its funding?
- How will members, clients or patrons hear about the organization’s activities? How many members, clients or patrons does the organization expect to serve? How is the organization distinguishable from for-profit entities, if any, with similar activities?

If, after reading other chapters of this Handbook, you realize that your organization plans to engage in activities or operate in a manner that might raise concerns for the IRS, it is probably best to address these issues head-on. For example, you could explain that “The organization accepts paid advertising in its newsletter and will file Form 990-T, and pay any tax due,” or “Although the organization performed referral services for members in the past, this activity never constituted more than 1% of the organization’s overall activities, and the board voted to discontinue this activity on [insert date].”

(b) Page 3—Part V, Questions 1b and 1c

Question 1b asks for compensation and other information regarding any employee who will receive more than \$50,000 per year from the organization. If no employee is expected to receive more than \$50,000 per year, simply insert a statement to that effect in response to this question. Similarly, if no independent contractor is expected to receive more than \$50,000, you can insert a statement to that effect in response to question 1c.

(c) Page 3—Part V, Question 2b

Question 2b asks whether the organization has a business relationship with any of its officers, directors or trustees, other than through their position as an officer, director or trustee. You would answer “yes” to this question if, for example, you planned to contract with one of your directors to provide fundraising or other services to the organization.

(d) Page 3—Part V, Question 4

The Form 1023 indicates that the practices regarding compensation for officers, directors, trustees and highly compensated employees and independent contractors reflected in this question are recommended, but not required. Nevertheless, answering “no” to any of these questions is likely to raise a red flag (or at least a yellow one) for the IRS agent reviewing your application. If you do answer no to any of these questions, it would be advisable to provide additional information describing why the organization has not adopted a particular practice and what other safeguards it has put in place to ensure that compensation

paid to officers, directors, trustees and highly compensated employees and independent contractors is no more than is reasonable.

(e) Page 4—Part V, Question 5

As noted above, although an organization is technically not required to have a conflict of interest policy, the IRS strongly suggests that every organization adopt such a policy, and the Instructions to Form 1023 include a sample document that can be adopted and included as part of the application.

(f) Page 4—Part V, Question 6

While 501(c)(3) organizations are not prohibited from compensating individuals through nonfixed payments, such as discretionary bonuses or revenue-based payments, such arrangements must be carefully designed to ensure that they result in reasonable compensation and are consistent with the rules applicable to 501(c)(3) organizations. See, for example, the discussion regarding intermediate sanctions in Chapter 28 if your organization intends to pay discretionary bonuses or make revenue-based payments, particularly if you intend to make such payments to directors, officers or highly compensated employees. It would be advisable to seek advice from a lawyer to be sure such compensation arrangements are appropriately structured.

(g) Page 4—Part V, Question 7

It is preferable if you can truthfully answer “no” to both parts of question 7, as a “yes” answer likely will raise a red flag with the IRS. As indicated in the IRS instructions, you do not need to answer yes simply because directors, officers or other persons described in this question can purchase goods or services from the organization on the same terms as the general public. Nevertheless, if the answer to either question is yes, you may be able to alleviate IRS concern by indicating that the purchase or sale of goods or services between the organization and the officer, director or other person described in this question will be approved consistent with the rebuttable presumption set out under the intermediate sanctions regulations. See Chapter 28.

(h) Page 4—Part V, Questions 8 and 9

As indicated with respect to question 7 above, a “yes” answer may raise concerns for the IRS, and such concerns may be alleviated by demonstrating that the organization understands and will follow the requirements necessary to obtain the rebuttable presumption of reasonableness under the intermediate sanctions regulations.

(i) Page 5—Part VI, Question 1a

Answer “yes” if your organization provides goods or services to individuals (e.g., educational programs for youth or food to homeless people). If your organization provides goods or services to individuals, you will want to demonstrate that you provide these goods or services in a manner that serves a charitable class, rather than a small, identifiable group of individuals. Also, if you sell goods or services, as opposed to just giving them away, you will want to show that your activities are structured in a manner that is different from the way a

for-profit entity would operate. Do not say that the organization's charges are based on cost. In the real world, of course, everyone must consider costs, but for the IRS, using cost as the sole basis for fees or charges may be a hallmark of a for-profit organization. Instead, survey what other nonprofits offering similar goods or services charge and base your fees on that; set your fees at a level that most people likely to need your services can afford; set your fees as low as you feasibly can, with the difference to be made up by donations; or establish a sliding scale for fees based on income and family size.

(j) Page 5—Part VI, Question 1b

As with question 1a above, the key here is to show how your provision of goods or services to organizations furthers your 501(c)(3) purposes. This may be easy if you provide goods or services to other tax-exempt organizations or government entities (e.g., by conducting park cleanups or providing free computers to small community-based nonprofits); however, if you charge for the goods or services you provide, you will need to distinguish your activities from the manner in which a for-profit entity would operate. (See comments regarding question 1a of Part VI above.)

(k) Page 5—Part VI, Question 2

If the answer to this question is “yes,” you will want to be sure that the class of individuals to whom the organization provides services is a large and indefinite group (e.g., homeless people, youth), rather than a small, identifiable group (e.g., the organization's members, residents of a single neighborhood, employees of a small company).

(l) Page 5—Part VI, Question 3

Generally, the answer to this question should be “no.” If the answer is “yes” (for example, because you are starting a community orchestra and you expect that relatives of your directors and officers will be among the members of the general public that will attend performances), you should explain that goods or services will be provided to such individuals only on the same terms as they are provided to the general public.

(m) Page 5—Part VII, Question 2

Hopefully, your answer to this question is “no.” Once an organization obtains tax-exempt status, this status generally will be retroactive back to the date of the organization's formation (i.e., incorporation), provided the organization submits its Form 1023 within 27 months of the end of the month in which it was incorporated (15 months, plus an automatic 12-month extension). If you are filing more than 27 months after the organization's formation, your organization still may obtain 501(c)(3) status from the postmarked date on your application and may be eligible for 501(c)(4) status from the date of formation to the date on which the application is postmarked. Also, in certain limited circumstances (discussed in Chapter 21 above and referenced in Schedule E of the Form 1023), the 27-month deadline may not apply.

(n) Page 5—Part VIII, Question 1

The answer to this question should be “no.”

(o) Page 5—Part VIII, Question 2

If the answer to this question is “yes,” you will want to provide enough information about your organization’s activities to make the IRS comfortable that you are aware of and will comply with the limitations on lobbying activity applicable to 501(c)(3) organizations. Also, if the answer to Question 2a is “yes,” the IRS will almost surely want the organization to make the § 501(h) election (meaning that the answer to Question 2b also should be “yes”). See Chapter 29.

(p) Page 5—Part VIII, Question 3

If the answer to this question is “yes,” you may wish to review IRS Publication 3079, which provides information on gaming for tax-exempt organizations, to understand whether your organization’s bingo or other gaming activity will be treated as unrelated trade or business activity and, if so, what the implications of this activity are for the organization. This publication is available through <http://www.irs.gov>. Also, you may wish to seek advice from a lawyer or accountant.

(q) Page 6—Part VIII, Question 4b

If the answer to this question is “yes”, the IRS will want enough information to assure itself that any compensation paid to the organization’s fundraisers is reasonable. Generally, it is best to avoid arrangements pursuant to which the fundraisers’ compensation is a percentage of the funds raised for the organization.

(r) Page 6—Part VIII, Question 4e

If the answer to this question is “yes,” you may wish to seek advice from a lawyer or accountant to be sure that you understand and can comply with the complex rules applicable to donor-advised funds.

(s) Page 6—Part VIII, Question 6a

If the answer to this question is “yes,” you may wish to seek advice from an attorney. While 501(c)(3) organizations may engage in economic development activities, the IRS will want to be sure that such activities are sufficiently circumscribed so as to be consistent with 501(c)(3) status. The instructions to this question give you a helpful summary of the facts and circumstances in which the IRS may find it acceptable for a 501(c)(3) organization to engage in economic development activities.

(t) Page 6—Part VIII, Question 7

Generally, the answer to questions 7a and 7b probably will be “no.” If the answer to either one is “yes,” you will want to provide the IRS with sufficient information to show that the arrangement does not result in undue benefit being provided to private interests and that your organization retains sufficient control over its assets. If you need to provide information in response to question 7c, you will want to establish that any such arrangements are approved pursuant to the organization’s conflict of interest policy.

(u) Page 6—Part VIII, Question 8

If the answer is “yes,” you will want to seek advice from an attorney.

(v) Page 6—Part VIII, Question 9

If the answer to question 9a is “yes,” the answers to question 9b through 9d generally also should be “yes.”

(w) Page 6—Part VIII, Question 10

If the answer to question 10 is “yes,” the organization generally should be the owner of the intellectual property. If the organization will not own intellectual property that it produces, this may raise a yellow flag for the IRS, and you may wish to consult with an attorney.

(x) Page 7—Part VIII, Question 11

If the answer is “yes,” you will likely want to seek advice from an attorney.

(y) Page 7—Part VIII, Question 13a

If the answer is “yes,” the IRS will want to be sure that appropriate safeguards are in place to ensure that the funds you grant to other organizations will be used only in furtherance of 501(c)(3) purposes. If you will make grants only to other 501(c)(3) organizations, the IRS will not require the same safeguards (e.g., applications, grant agreements and detailed record-keeping) that it expects if you make grants to non-501(c)(3) organizations. If you are a private foundation, grants to non-501(c)(3) organizations will be taxable expenditures that trigger excise tax penalties under § 4945 unless you comply with certain additional administrative requirements (e.g., expenditure responsibility or equivalency determination procedures). Thus, if your organization is a private foundation that intends to make grants to non-501(c)(3) organizations, you may wish to consult an attorney.

(z) Page 7—Part VIII, Question 14a

If the answer to question 14a is “yes,” the answer to question 14c should be “no” and the answers to questions 14d through 14f should be yes. See Chapters 35-42 for a discussion regarding international grantmaking.

(aa) Page 9—Part IX-A, Statement of Revenues and Expenses

The IRS usually requires both actual financial information to date and a two-year projected budget. Many organizations feel it is difficult to predict what the financial future holds; however, the IRS will, of course, require a projected budget even if you find it difficult to prepare. Just remember that you do not have to become a fortuneteller—a good-faith estimate of future revenues and expenses is sufficient.

Some organizations find that it works best to start with the goals the group wants to accomplish, estimating, goal by goal, what the planned activities will cost, and then creating a strategy to come up with the necessary income. For other organizations, it makes more sense to start with projected income when budgeting. For instance, a membership group can estimate the number of people who might join, as well as the amount of dues members might be willing to pay, and then decide how much of the available money will be spent on each of the organization's planned programs. Make sure that the description of the organization's programs in Part II is consistent with the financial information presented here.

When you are completing the statement of revenues and expenses, be sure to watch for the lines that request schedules and to provide such schedules as attachments.

(bb) Page 10—Part IX-B Balance Sheet

The statement of revenues and expenses is a summary of the organization's financial activity over a period of time, while the balance sheet is a snapshot of what the organization owns and owes on a particular given date. The IRS prefers that an organization's balance sheet reflect its assets and liabilities as of the end of its most recently completed tax year. If the organization has not completed a tax year, provide information that is effective as of the last day of the most recent month before filing the Form 1023 with the IRS.

(cc) Page 10—Part X, Public Charity Status

When the IRS issues a favorable 501(c)(3) determination letter, it is actually two rulings in one. In addition to recognition of 501(c)(3) status, the IRS rules on "Foundation Status," a sort of subcategory under 501(c)(3). As discussed above in Chapter 21, all 501(c)(3)s fall into one of two broad categories—public charities or private foundations.

An organization that cannot show that it qualifies for public charity status will be considered a private foundation. Generally, private foundations receive most of their support from a limited number of sources, such as one family, one corporation, or investments. It is generally less favorable to be a 501(c)(3) private foundation because these organizations must pay tax on income from interest, dividends, capital gains and other passive income and are subject to a wide variety of restrictions with respect to how they invest their assets and conduct their operations. For a more detailed discussion of this distinction, see "Public Charities and Private Foundations" in Chapter 21. Also, Chapter 3 of IRS Publication 557 and the instructions to Part IX of the Form 1023 provide useful information to help you determine the appropriate category for your organization.

(dd) Page 10—Part X, Question 1—Private Foundation

The answer to this question would be "yes" if you do not answer "yes" to question 2 or check one of the boxes under question 5. If you believe your organization will not qualify for one of the public charity categories listed under question 5, you may wish to consult with an attorney to be sure you understand and can comply with the rules applicable to private foundations.

(ee) Page 10—Part X, Question 2—Private Operating Foundation

True “private operating foundations” are rare. An organization that believes it is a private operating foundation should probably have its application professionally prepared.

(ff) Page 10—Question 5—Reason for Public Charity Status

Some organizations are “public charities” solely because of the activities they carry on (churches [box 5a], schools [box 5b], hospitals [box 5c], or supporting organizations [box 5d]). If you check any of these boxes, be sure to complete the appropriate schedule.

Other organizations are “public charities” because they receive at least 33⅓% of their support from the general public. Organizations whose public support is mostly in the form of gifts, grants and contributions are described in Code §§ 509(a)(1) and 170(b)(1)(A)(vi), and would check box 5g. Organizations whose public support is mostly in the form of payments for goods or services, such as fees for admission to cultural events or educational seminars, are described in Code § 509(a)(2), and would check box 10g. Many organizations have a mixture of types of income. You may check box 10i and let the IRS decide between these two public support categories for you.

(gg) Page 11—Part X, Question 6—Advance Ruling

Advance rulings are no longer given. Therefore, this question should not be answered. See instructions to Form 1023.

(hh) Page 12—Part XI, User Fee Information

The IRS charges a nonrefundable processing fee for exemption applications. There is currently a two-tiered fee schedule. Organizations with gross receipts that have averaged, or will average, not more than \$10,000 per year pay \$300. Larger organizations pay \$750. These amounts are subject to change, so you should check the most current Form 1023 available for the correct amount required. If you pay the lower User Fee, be sure that the information provided in the statement of revenues and expenses submitted as part of the Form 1023 (part IX) is consistent with your representation showing that gross receipts have averaged or will average less than \$10,000 each year. The IRS does not begin processing an application until the check for the User Fee has cleared, so you may speed up your application slightly by paying with a cashier’s check or money order. A new IRS revenue procedure announcing the User Fee comes out each January; if you are submitting your application late in the year, there may be some benefit to submitting it before January 1.

(ii) Page 13+—Additional Schedules

Unfortunately, the space considerations for this text do not allow us to deal with these additional schedules. If your organization is required to complete one of these schedules, please refer to the relevant Form 1023 instructions.

e. **Assembling Your Application**

After you have completed your Form 1023 and relevant attachments, refer to “Form 1023 checklist” (the last two pages of Form 1023). This checklist describes the order in which Form 1023 and documents that accompany it should be compiled for submission and provides the address to which your application should be submitted. Before submitting your application, make certain that all applicable parts of the form are completed, including any required schedules. As noted above, attachments should be inserted in the appropriate spot within the pages of the application itself (i.e., behind the page of the application that references the attachment) to facilitate IRS review. Each attachment should be labeled with the organization’s name and employer identification number and the question number to which the attachment relates. All other attachments, including articles of incorporation, bylaws, brochures and conflicts of interest policies, should be labeled with the organization’s name and EIN. **Be sure to place your check or money order, payable to the United States Treasury, in an envelope on top of the checklist.**

An authorized person, usually the president of the board of directors or other officer, rather than the executive director, must sign the form. Part XI of the application inquires about the organization’s gross annual receipts, which determines the amount of User Fee required. See discussion in Chapter 24 for more information on inclusion of the User Fee with the application. Following the User Fee determination, an authorized person (i.e., an officer of the organization) must sign the declaration portion of the Form. The declaration is a statement that the application is true, correct and complete.

Chapter 23. Obtaining Recognition for a Publicly Supported Charity

Until 2008, the IRS required that new 501(c)(3) organizations demonstrate eligibility to be recognized as a public charity before issuing a final determination that the organization received sufficient public support to qualify. From 2008 onwards, a new organization will be classified as a public charity by virtue of its public support if it can show on its Form 1023 that it reasonably can be expected to meet the applicable public support test (see Chapter 21 for discussion of the differences between public charities and private foundations). During the first five years of operation, the organization retains its status as a publicly supported organization without regard to the calculation of the “public support test” on Schedule A of the Form 990. Beginning with the organization’s sixth taxable year, the organization must show that it meets the public support test based on prior years’ public support in order to remain classified as a publicly supported organization.

Under the prior rules, the organization was responsible for requesting a final determination (using Form 8374) at the end of the “advance ruling” period (i.e., at the end of its initial five years of operation). This process is no longer required. Discussions of this topic prepared before the change in the process will refer to the advance ruling period and to Form 8374.

Chapter 24. IRS Processing of Exemption Applications

a. Mailing Address

Form 1023 (Application for Recognition of Exemption Under Section 501(c)(3) of the Code) and instructions are available at <http://www.irs.gov>. The instructions and checklist accompanying the form contain the mailing address for the application. If you choose to submit the application by regular mail, it is a good idea to send it certified mail so that you have confirmation of the date the application is received by the IRS.

b. Expedited Handling

Many applicants are interested in expedited handling. The IRS is reluctant to consider any application out of turn but will sometimes be persuaded if an organization can show that it will lose funding from an unrelated third party, such as a grantmaking foundation, if the organization does not receive expedited handling. To ensure that a request for expedited handling is not overlooked, place it on top of all other materials sent to the IRS and type “Request for Expedited Review” in large, bold type to call attention to the request. See page 3 of the Form 1023 instructions for more information about requesting expedited review.

c. User Fee

As noted above, the IRS does not begin processing an application until the check for the User Fee has cleared, so you may speed up your application slightly by paying with a cashier’s check or money order. If you pay by check, watch your bank statements to make sure the IRS does, in fact, cash the check for the User Fee. If the User Fee check is not promptly cashed, it is an indication that the application may have been lost in the mail. When the IRS has confirmed payment, a brief letter is sent to the applicant acknowledging receipt of the application and describing the IRS process with regard to applications.

d. Processing

Upon receipt by the IRS, exemption applications are initially separated into three groups: (1) those that can be processed immediately based on information submitted, (2) those that need minor additional information to be resolved, and (3) those that require additional development.

If your application falls in the first or second group, you generally will receive either your determination letter or a request for additional information, via phone, fax, or letter, within approximately 60 days of the date the application was submitted. If your application falls within the third group, you will be contacted once your application has been assigned to an IRS Exempt Organizations specialist. If you are curious about the status of an application you have submitted, you can go to the “Charities and Non-Profits” portion of the IRS website. Click on “Where is My Exempt Application” for information regarding the month in which applications currently being assigned to Exempt Organizations specialists were submitted.

e. Inquiry Letter

Applications that cannot be closed immediately based on the information initially provided require additional development. Processing of an application that requires additional development may take as long as six to eight months (or longer) to complete.

When an inquiry letter is sent, the applicant will normally have 21 days to respond. Upon request of the applicant, accompanied by an explanation as to why an extension is required, the agent handling the case will routinely grant an extension of ten days to two weeks. Sometimes the agent will even agree to grant a second extension, if requested. If that will not be enough time, however, the IRS may prefer to close the case. The file is kept available for up to one year and reopened automatically when additional information comes in; however, the IRS will charge a new User Fee if information is submitted more than 90 days after a case is closed. If your case is closed, you will receive a letter letting you know the date on which this 90-day period terminates.

f. Final Disposition

Once you have answered all of the IRS agent's questions satisfactorily, the IRS will issue a favorable determination letter.

If the IRS denies an application, the IRS must provide a written explanation of the facts, law, and argument upon which its decision is based, as well as an explanation of your appeal rights.

g. Public Disclosure of Form 1023

A 501(c)(3) organization generally must furnish a copy of its Form 1023 exemption application (including any attachments, questions asked by the IRS subsequent to the submission of the initial application and the organization's responses to such questions) to any person who requests a copy. More details about the disclosures required and the process for disclosures can be found in Chapter 33.

PART V. MAINTAINING FEDERAL TAX-EXEMPT STATUS FOR YOUR 501(c)(3) ORGANIZATION

Chapter 25. Continuing Obligations Under Federal Tax Law

When an organization receives a determination from the Internal Revenue Service that it is qualified under § 501(c)(3) of the Code, this is the beginning, not the end, of a compliance process that will continue throughout the organization's life. An organization must continue at all times to comply with tax law requirements in order to maintain its tax exemption. Specifically:

- The organization must be organized and operated at all times exclusively to further charitable purposes;
- It must not allow any of its assets to “inure” to the benefit of an “insider”;
- It must not participate in any campaign for political office;
- It must not engage in attempts to influence legislation as any substantial part of its activities;
- It must report and pay tax on any unrelated business income; and
- It must comply with a variety of annual reporting and public disclosure requirements.

Each of these issues is addressed in more detail below. In general, this Part addresses 501(c)(3) organizations that are qualified as public charities (non-private foundations) under federal law. A more restrictive set of rules applies to 501(c)(3) organizations that are private foundations. The private foundation rules are beyond the scope of this text but are introduced and discussed briefly in Chapter 21. A special set of rules also applies to public charities that are classified as “supporting organizations.” An organization is a supporting organization if its IRS determination letter identifies it as an organization described in Code § 501(a)(3). The supporting organization rules are beyond the scope of this Handbook.

Chapter 26. Charitable Purposes

Federal tax law provides that for an organization to qualify for tax exemption under Code § 501(c)(3), it must be organized and operated exclusively for charitable, religious, scientific, educational, and certain other purposes. In order to maintain its tax-exempt status, a § 501(c)(3) organization must comply with this standard throughout its entire period of existence. If its purposes change—either in terms of how its purposes are stated in its articles of incorporation and bylaws, or in terms of the organization's activities—its qualification for exemption may also change.

The tax law recognizes a wide variety of purposes and activities as being “charitable.” While § 501(c)(3) enumerates other qualified purposes, such as religious and educational purposes, the law interprets these as subsets of the general category of charitable purposes,

not as separate categories. Charitable purposes include relief of the poor, the advancement of religion, the advancement of education or science, the erection or maintenance of public buildings or monuments, lessening the burdens of government (in limited circumstances), promoting social welfare, lessening neighborhood tensions, eliminating prejudice and discrimination, defending human and civil rights secured by law, combating community deterioration and juvenile delinquency, and protecting the natural environment. Educational purposes, as a subset of charitable purposes, include both instruction of the public and the individual. Educational activities include educational publications as well as literary, visual and performing arts.

In order for an organization's activities to qualify as charitable, they must benefit the general public or a segment of the general public that is broad enough to be considered a charitable class. For example, an educational organization formed to educate the children of one family will not qualify as charitable. In addition, activities that violate public policy, such as the provision of education on a racially discriminatory basis, will not qualify as charitable.

“Exclusively” for Charitable Purposes Means “Substantially.” While the tax law specifies that a 501(c)(3) organization must be organized and operated “exclusively” for charitable purposes, the Treasury Regulations provide that an exempt organization may also engage in activities that do not specifically further a charitable purpose, provided that such activities do not constitute more than an “insubstantial” part of the organization's total activities. Accordingly, a 501(c)(3) organization may engage in a limited amount of activities that are not strictly charitable, so long as the activities do not violate any of the rules described in Chapters 27, 29, 30 & 31.

The Activity Itself Must Be Charitable. Each of the organization's activities must be evaluated separately to determine whether it furthers a charitable purpose. The fact that funds generated from an activity may ultimately be used to further a charitable purpose will not by itself cause the activity to be charitable. For example, the operation of a sandwich shop for paying customers is not charitable even though all net income from the shop may be used for charitable purposes. The operation of a soup kitchen for the homeless, on the other hand, is charitable.

Chapter 27. Private Inurement

a. General Prohibition

A 501(c)(3) organization must be operated in such a manner that none of the organization's assets “inures to the benefit” of any private individual. Private inurement occurs when a person who is an “insider” with respect to the organization, such as an officer or director, derives a benefit from the organization without giving something of at least equal value in return.

The determination of whether a person is an insider is based on all relevant facts and circumstances and will generally depend on the level of influence that the individual has over the organization. Entities such as corporations and partnerships that are controlled by insiders may also be treated as insiders with respect to an exempt organization. For example, a

corporation that is wholly owned by a board member of the organization will likely be an insider with respect to the organization.

In order to identify and avoid potential private inurement situations, an organization should adopt a conflict of interest policy and should annually survey its board members, officers and senior staff to identify all organizations in which they or their family members have substantial interests and to identify all situations in which the organization has financial dealings with potential insiders. The organization must take care to insure that all such arrangements are entered into at “arm’s length” and are in the best interest of the organization.

The IRS may revoke an organization’s tax-exempt status if any private inurement occurs. As a technical matter, there is no de minimis exception. Private inurement may arise in many ways. Some of the most common situations are described below.

b. Compensation Arrangements

A 501(c)(3) organization may pay reasonable compensation to employees or others for services rendered. Excessive compensation, however, such as compensation that exceeds payments commonly made by similar organizations for similar services, may result in inurement. In order to avoid private inurement, it is advisable for an organization to follow the procedures to create a “rebuttable presumption” of reasonableness discussed below in Chapter 28.

As a general rule, a 501(c)(3) organization should not pay any person a salary or other compensation that is calculated as a percentage of the organization’s net earnings. For example, an organization must not pay its executive director a salary calculated as 10% of the organization’s net income. This would be private inurement and could result in revocation of the organization’s federal tax exemption.

c. Purchases and Sales

If a 501(c)(3) organization purchases property or services from an insider for more than adequate consideration or pays rent in excess of fair market value, this may constitute private inurement. Similarly, if an organization furnishes property or services to an insider without receiving adequate compensation, inurement may result. If the organization provides property or services for less than fair market value to the general public in the course of fulfilling its tax-exempt purposes (e.g., an orchestra performing free concerts), private inurement generally will not result.

d. Loans

If a 501(c)(3) organization borrows money from an insider at a rate of interest that is above market rate or loans money to an insider without receiving adequate security or reasonable interest, this may also result in private inurement.

e. Joint Venture Arrangements

Inurement may also arise from joint venture arrangements between 501(c)(3) organizations and for-profit entities, especially in situations where, under the joint venture arrangement, the for-profit entity enjoys unfettered control over the exempt organization's assets or operations or receives a percentage of its net earnings.

Chapter 28. Intermediate Sanctions

a. Overview

The penalty for private inurement, as discussed above, is revocation of the organization's tax exemption. The tax law also imposes penalties on certain persons who engage in impermissible transactions with charitable organizations. The IRS may impose such penalties as an intermediate step instead of revoking the organization's exempt status, or it may penalize individuals in addition to revoking exemption.

b. Outline of Penalties

The tax law imposes a penalty tax on any "disqualified person" (defined below) who engages in an "excess benefit transaction" (defined below) with certain organizations that are exempt from tax under §§ 501(c)(3) and 501(c)(4), and on "organization managers" who knowingly and willfully approve such transactions.

Initially, the tax on a disqualified person is 25% of the excess benefit that the disqualified person received. For example, if the person sold property to the organization for \$10,000 when the fair market value was really \$4,000, the excess benefit is \$6,000 and the initial tax is \$1,500 (25% of \$6,000). If the transaction is not "corrected" (i.e., undone to the extent possible by, for example, returning the excess benefit amount to the organization), the disqualified person is subject to an additional tax of 200% of the excess benefit. In our example, the additional tax is \$12,000.

In addition, an "organization manager," such as a board member, officer or executive director, may be subject to a separate tax if the manager approves an excess benefit transaction knowing that it is an improper transaction, unless the action is not willful and is due to reasonable cause. The tax is 10% of the excess benefit, up to a maximum of \$20,000 for each excess benefit transaction. In our example, the tax on an organization manager would be \$600.

The intermediate sanctions rules do not impose a penalty tax on the exempt organization itself.

c. "Disqualified Person"

A "disqualified person" is any person who is in a position to exercise substantial influence over an organization with respect to a transaction. Once a person is classified as a disqualified person, he or she will continue to be a disqualified person for a period of five years after he or she ceases to exercise such influence. A member of any disqualified

person's family is also a disqualified person, as is a corporation, partnership, trust or estate in which a disqualified person directly or indirectly owns more than a 35% interest.

Under the Treasury Regulations, a voting member of a 501(c)(3) organization's governing body is automatically a disqualified person, as are the organization's president, chief executive officer, chief operating officer, treasurer, and chief financial officer and any management company that performs services for the exempt organization. An individual's authority and responsibilities, rather than the person's title, determines whether he or she holds one of these positions. An individual who has or shares ultimate responsibility for implementing the governing body's decisions or supervising the organization's management, administration or operations will be a disqualified person, as will anybody who has or shares ultimate responsibility for managing an organization's financial assets, including check-signing authority and authority to authorize electronic fund transfers.

The Treasury Regulations provide that an employee who receives economic benefits from an exempt organization of less than \$80,000 per year is not a disqualified person, so long as the individual is not otherwise a disqualified person under one of the categories above. For example, an executive director who receives \$30,000 per year will be a disqualified person by virtue of his or her role as chief executive officer, regardless of the fact that his or her salary is less than \$80,000.

In cases not covered by the rules above, the question of whether a person is a disqualified person is determined on the basis of all relevant facts and circumstances bearing on the person's level of influence over the organization with respect to a transaction.

d. "Excess Benefit"

An "excess benefit transaction" is any transaction in which a 501(c)(3) or 501(c)(4) organization provides an economic benefit, either directly or indirectly, to a disqualified person, where the value of that economic benefit exceeds any value that the organization receives in return, including the value of services performed. For example, the payment of a salary of \$50,000 for services, where the fair market value of the services is \$25,000, is an excess benefit transaction.

The Treasury Regulations provide that the payment of reasonable expenses for board members to attend meetings, as long as these do not include luxury travel or payments for spouses, do not constitute excess benefit transactions. Similarly, benefits that are provided to members of the public in exchange for an annual membership fee of \$75 or less, such as discounted admission to events or receipt of a newsletter, do not constitute excess benefits.

e. Rebuttable Presumption of Reasonableness

An organization can establish a rebuttable presumption that a transaction is reasonable (and therefore not an excess benefit transaction) when the three requirements set out below are satisfied. In general, organizations should seek to satisfy the rebuttable presumption in approving any transaction with a potential disqualified person. If an organization is unable to establish the rebuttable presumption for a transaction, however, there is no inference that it is an excess benefit transaction. The three requirements are:

- **Approval by Independent Board or Committee.** The transaction must be approved by a board or committee composed entirely of individuals who are not themselves disqualified persons with regard to the transaction and are not related to or controlled by a disqualified person.
- **Appropriate Comparability Data.** The board or committee must rely on appropriate comparability data. The issue of what data is appropriate is critical. Where the transaction involves the purchase or sale of property, an independent appraisal is appropriate data.

Where the transaction involves the payment of executive compensation, the board or committee should obtain a carefully tailored compensation survey that considers a variety of factors, such as geographic location, the size of the organization, relevant experience and comparability of services. A special rule applies for organizations with annual gross receipts of less than \$1 million. In this case, comparability data for compensation is appropriate if it consists of compensation paid by three comparable organizations in the same or similar communities for similar services. An informal survey of similar organizations can accordingly be essential in establishing the rebuttable presumption.

- **Concurrent Written Documentation.** The board or committee must concurrently document the basis for its decision in writing, e.g., through minutes. The written documentation must include the terms of the transaction; the date it was approved; the members of the board or committee who were present during debate and those who voted on it; the comparability data obtained and how it was relied on; and the action taken by anyone who is a member of the board or committee but who had a conflict of interest. In order for the decision to be documented concurrently, the records must be prepared by the time of the next board or committee meeting and must be approved within a reasonable period.

Chapter 29. Political Activity

Federal tax law prohibits any 501(c)(3) organization from participating in any political campaign on behalf of or in opposition to any candidate for public office. This prohibition is absolute, and any violation may result in loss of an organization's exempt status. The prohibited activity includes publishing or distributing written statements or making oral statements on behalf of or in opposition to a candidate, and paying salaries or expenses of campaign workers.

501(c)(3) organizations must take care to avoid any inadvertent violation of the prohibition against political activity. For example, an organization should not invite a candidate to speak at an organization-sponsored function during an election cycle, because this may be treated as an implicit endorsement. Organizations should also refrain from publishing voter education materials that may create an appearance of bias regarding issues that are significant to the organization, e.g., a "voter's guide" that compiles incumbents' voting records only on issues that are important to the organization.

Chapter 30. Legislative Activity (“Lobbying”)

a. “No Substantial Part” Limitation

The tax law distinguishes “political activity” (i.e., participating in campaigns for political office) from attempts to influence legislation. An organization engages in attempts to influence legislation (commonly referred to as “lobbying”) if it contacts legislators or their staffs—or urges the public to do so—for the purpose of proposing, supporting or opposing legislation.

A 501(c)(3) organization that is a public charity may engage in lobbying, but only if such activities do not constitute a “substantial” portion of the organization’s activities. If the IRS determines that a public charity has engaged in substantial attempts to influence legislation, the organization’s exemption may be revoked. It is unclear when lobbying activity will be deemed to constitute a “substantial” portion of an organization’s activities; there is no precise standard.

Certain other types of tax-exempt organizations, e.g., social welfare organizations qualifying under § 501(c)(4), are not subject to limitations on legislative activities. If an organization wishes to engage primarily in lobbying, it should seek exemption under a category other than § 501(c)(3).

b. § 501(h) Election

(i) Generally

Most 501(c)(3) organizations that are public charities, other than churches, may make an election under § 501(h) of the Code to become subject to a more objective standard for lobbying activities than the vague “substantiality” test. Section 501(h) provides specific dollar limits on lobbying expenditures. An organization making the election may spend up to 20% of the first \$500,000 of its annual operating budget on lobbying. (Only 25% of that amount may be spent in “grassroots” lobbying, however, as defined below.) As an organization’s annual budget increases over \$500,000, the percentage that may be spent on lobbying decreases. There is an absolute annual maximum on lobbying expenditures of \$1 million, which is reached at an annual budget of \$17 million.

If an organization exceeds its limit in any year, it will be subject to an excise tax of 25% on the excess amount. An organization that has made a 501(h) election will lose its tax exemption on the basis of excessive lobbying only if the organization exceeds its permitted expenditures by 150% over a four-year period.

The election is made by filing Form 5768 with the IRS, which can be obtained at <http://www.irs.gov/pub/irs-pdf/f5768.pdf>.

(ii) Advantages of the § 501(h) Election

The principal advantage of the § 501(h) election is that it avoids the ambiguity of the vague “substantiality” test. The election also allows an organization to take advantage of specific exceptions to what constitutes lobbying under the tax law. In general, the § 501(h)

election allows an organization to plan lobbying expenditures with much greater certainty regarding the tax result. In addition, the excise tax that applies to excessive lobbying expenditures of an electing organization is much less harsh than the loss of tax-exempt status that can apply to a non-electing organization. An organization that anticipates any regular attempts to influence legislation is generally well-advised to make the § 501(h) election.

c. “Attempts to Influence Legislation” Under § 501(h)

(i) “Legislation”

“Legislation” includes action by the Congress, state legislature, local council, or similar legislative body, or by the public in a referendum, ballot initiative, constitutional amendment or similar procedure. It includes both legislation that has already been introduced in a legislative body and a specific legislative proposal that the organization either supports or opposes. It does not, however, include executive action, judicial processes, or the work of administrative agencies such as school boards, housing authorities, sewer and water districts and zoning boards, whether elective or appointive. Attempts to influence the actions of regulatory agencies accordingly are not lobbying, even where the agency is primarily concerned with promulgating regulations to effectuate legislative mandates.

(ii) Direct Lobbying Communication

Attempts to influence legislation include “direct” lobbying, defined as communications with any member or employee of a legislative body or any governmental official or employee who may participate in formulating legislation if the principal purpose of the communication is to influence legislation. A communication with a legislator or governmental official will be treated as a direct lobbying communication if it (1) refers to specific legislation; and (2) reflects a view regarding the legislation.

(iii) Grassroots Lobbying Communication

Attempts to influence legislation also include “grassroots” lobbying communications. These are communications that attempt to affect the opinion of the general public or a segment of the public and that (1) refer to specific legislation; (2) reflect a view regarding the legislation; and (3) encourage the recipient to “take action.”

A communication encourages the recipient to take action if it (1) encourages the recipient to contact a legislator; (2) gives the addresses, telephone number or other contact information for the legislator; (3) provides a petition or tear-off postcard for the recipient to communicate with the legislator; or (4) specifically identifies one or more legislators who will vote on the legislation. Paid mass media advertisements within two weeks before a vote on a highly publicized piece of legislation will be presumed to constitute grassroots lobbying if the advertisement reflects a view and encourages communication with legislators, even if it does not encourage the recipient to take action.

d. Exceptions to Definition of “Attempts to Influence Legislation”

(i) Nonpartisan Analysis, Study or Research

A 501(c)(3) organization may provide the public or legislators the results of any of its “nonpartisan analysis, study or research.” This includes any independent and objective exposition of a particular subject matter, including educational materials. The materials may advocate a particular position, so long as they present sufficient facts to allow the audience to form independent conclusions. If the communication directly encourages the recipient to take action with respect to specific legislation, then it is excluded from this exception.

(ii) Technical Advice or Assistance

An organization that has developed a particular expertise in a given area may be called upon to render technical advice or assistance to a legislative committee or subcommittee. Provided that the invitation to do so is issued in writing by the committee or subcommittee, rather than an individual member, the organization’s response to that request will not constitute lobbying activity.

(iii) “Self Defense”

An electing organization may appear before or communicate with any legislative body with respect to a possible decision of that body that might affect the organization’s existence, its powers and duties, its tax-exempt status, or the deductibility of its contributions.

(iv) Examinations and Discussions of Broad Social, Economic and Similar Problems

The participation in, or sponsorship of, public discussion on issues of general concern will not constitute lobbying, provided that such discussion does not address the merits of a specific legislative proposal and does not directly encourage participants to take action with respect to legislation.

Chapter 31. Unrelated Business Income (“UBI”)

a. Tax Liability

While a 501(c)(3) organization is not generally subject to federal income taxation on its income, it will be taxed on any net income derived from an “unrelated trade or business.” Such income is referred to as unrelated business income, or “UBI.” UBI is taxed at graduated rates that apply to taxable corporations or trusts (depending on the legal form of the organization involved).

The purpose of the UBI tax is to treat exempt organizations in the same manner as their taxable counterparts when they are regularly engaging in income-producing activities that do not further a charitable purpose. An organization’s tax exemption may be jeopardized if a substantial part of its activities constitutes unrelated business activities.

b. “Unrelated Trade or Business”

An exempt organization’s activity will constitute an unrelated trade or business if all of the following three factors are present:

(i) Trade or Business

The activity is a trade or business, defined as any activity carried on for the production of income from selling goods or performing services.

(ii) Regularly Carried On

The trade or business is frequent, continuous and pursued in a manner similar to comparable activities of nonexempt organizations.

(iii) Not Substantially Related

The trade or business is not substantially related to the organization’s exempt purpose. An activity is substantially related if the conduct of the activity has a substantial causal relationship to the achievement of exempt purposes (other than the production of income). In short, the activity must contribute importantly to the organization’s exempt purposes. It is not enough that the net income from the activity will be used to further charitable purposes. The conduct of the activity must itself be charitable. For example, the operation of a restaurant where all net income will be used for charitable purposes is not charitable. On the other hand, the operation of a restaurant used exclusively as a job-training program for indigent persons may be charitable.

c. Exceptions for Certain Activities

Certain activities are excluded from the definition of an unrelated trade or business, and income from these activities accordingly is not UBI.

(i) Volunteer Exception

A business in which substantially all of the work is carried on by uncompensated volunteers does not generate UBI. For example, operation of a retail store where all of the work is performed by unpaid volunteers is not an unrelated trade or business, and any income generated is not UBI.

(ii) Convenience Exception

A business carried on primarily for the convenience of an exempt organization’s members, students, patients, officers or employees is not an unrelated trade or business, and does not generate UBI. For example, a hospital cafeteria for employees, patients and visitors does not generate UBI.

(iii) Donated Merchandise

A business of selling merchandise, substantially all of which has been donated to the organization, is not an unrelated trade or business and does not generate UBI. For example, a

retail thrift store in which all merchandise sold has been donated to the organization does not generate UBI.

(iv) Exclusions for Investment Income

The following are excluded from UBI, and therefore generally are not taxable, on the grounds that they are passive income from investment assets:

- Dividends, royalties, interest and annuities are all excluded from UBI.
- Rents from real property and personal property are excluded, but income from debt-financed real property, discussed below, may be UBI.
- Gains from the sale or exchange of property are generally excluded. For example, a 501(c)(3) organization is not subject to tax on gain on its sale of stock. If the organization regularly sells items that constitute inventory, however, and the sales activity does not further charitable purposes (e.g., sales of commercial magazines), then the income may be taxable.

(v) Deductions

Each 501(c)(3) organization is permitted a “standard deduction” in the amount of \$1,000 against any UBI earned in a taxable year, which amounts to an effective exemption from tax on the first \$1,000 of UBI. Organizations may also deduct expenses attributable to unrelated business activities in calculating net UBI.

(vi) “Debt-Financed Income”

While rents from real property are generally excluded from UBI, income from “debt-financed property” is not. The rules regarding debt-financed property are complex and confusing, and a full discussion is beyond the scope of this text.

Essentially, the policy behind the rules is as follows. It may be appropriate generally not to tax an organization on traditional investment income such as interest, dividends and rents, because this is the type of income that a charity typically earns from investment of its endowment. Such items should be taxed, however, to the extent that the organization borrowed to acquire the income-producing property, where the use of the property is not in and of itself charitable.

For example, assume that an organization acquires a building, subject to a mortgage for 80% of the purchase price, and uses half of the building for its administrative offices and its charitable purposes, while it leases the other half of the building to other organizations. The rental activity itself is not charitable. Under the debt-financed income rules, 80% (the percentage that was debt-financed) of the net rental income (after deduction of related expenses) will accordingly be taxed as UBI.

d. Excessive UBI May Jeopardize Exemption

An exempt organization's tax-exempt status may be jeopardized if more than an "insubstantial part" of its activities constitutes unrelated business activities. While there is no precise quantitative test for "substantiality," the IRS has ruled that there is no quantitative limit so long as an organization carries on a charitable program "commensurate in scope with its financial resources." The IRS has also ruled that UBI constituting 5% of an organization's gross income does not jeopardize its tax exemption.

If an exempt organization's status is threatened by the extent of its unrelated business activities, it should consider spinning off the unrelated activity into a for-profit subsidiary. Assuming that proper corporate formalities are met, the subsidiary's activities should not affect the parent's exempt status. The subsidiary will be taxed on net income from its activities.

Chapter 32. Federal Filing Requirements

a. Annual IRS Form 990

(i) Filing Requirement

Most tax-exempt organizations must file an annual information return with the IRS. For 501(c)(3) organizations that are public charities, and most other types of tax-exempt organizations, the return is made on IRS Form 990 or Form 990EZ. Failure to file the return for three consecutive years will result in loss of tax exemption.

For tax years beginning in 2008, the IRS has substantially revised Form 990, and it has become more complex to complete. Small organizations may be eligible to file the simpler Form 990EZ under phase-in rules. See the Instructions to Form 990, available at <http://www.irs.gov/formspubs/lists/0,,id=97817,00.html>.

(ii) Exceptions

Tax-exempt organizations (other than private foundations and "supporting organizations") that do not normally receive more than \$25,000 in gross receipts each year are not required to file an information return. Churches and certain religious organizations that are affiliated with a church are not required to file.

(iii) Annual Notice Requirements for Small Organizations

Effective for tax years beginning in 2007, small organizations (i.e., those that do not normally receive more than \$25,000 in annual gross receipts) that are not required to file Form 990 must instead file an annual electronic notice with the IRS reporting basic organizational information. **Failure to file the electronic notice for three consecutive years will result in loss of exemption.**

(iv) Filing Date

The return or the electronic notice must be filed on or before the 15th day of the fifth month following the close of an organization's annual tax accounting period (i.e., May 15 for a calendar-year organization).

(v) Professional Preparation

An organization may, at its election, either prepare its own Form 990 returns or utilize a professional service. 501(c)(3) organizations that rely on a public support test for public charity classification should seriously consider engaging a professional accountant with experience in preparing this type of return.

(vi) Treatment as a Public Relations Document

Form 990 returns are public documents. A 501(c)(3) organization must disclose to the public its Form 990 returns for the three most recent tax years. Accordingly, a tax-exempt organization should consider its Form 990 returns to be public relations tools and should treat the preparation process as an opportunity to advertise the organization's programs and good works to the public.

(vii) Penalties

Failure to file a Form 990 in a timely manner may result in penalties of \$20 per day, with a cap of the lesser of \$10,000 or 5% of the organization's gross receipts for the year. For large organizations (gross receipts exceeding \$1 million for any year), the penalty is \$100 per day, with a cap of \$50,000. The penalty may be abated if reasonable cause can be shown. An incomplete Form 990 return may be treated as a failure to file, with penalties assessed.

(viii) Organizations With a Tax Exemption Application Pending

Organizations that have applied for tax exemption but have not yet received a determination letter should file a Form 990 or other applicable form as if their tax-exempt status had been granted.

b. Form 990T: Organizations With UBI

An exempt organization that has more than \$1,000 of UBI in a taxable year must report such income on Form 990T, which must be filed in addition to the informational Form 990. Exempt organizations are also required to make quarterly estimated UBI tax payments, calculated at corporate rates. Penalties apply for late filing, late payment or underpayments of taxes on income reportable on Form 990T. Organizations generating UBI are well-advised to seek the assistance of an accountant.

c. Federal Returns and Reports Required of Organizations With Employees

- **Federal Income Tax Withholding.** Most tax-exempt organizations are required to withhold and pay federal income tax with respect to wages of their employees in the same manner as for-profit organizations. Organizations

should consult a bookkeeper, accountant or payroll management advisor regarding this and the other requirements listed in this section. See Chapter 64.

- **Social Security Taxes.** Most tax-exempt organizations are required to withhold and pay Federal Insurance Contributions Act (“FICA”) taxes in the same manner as for-profit organizations. See Chapter 64.
- **Federal Unemployment Taxes.** A 501(c)(3) organization is not required to pay federal unemployment taxes, but may elect to participate in a state program. See Chapter 64.
- **Information Returns for Payees.** Tax-exempt organizations are required to prepare and file annually certain forms for purposes of reporting amounts paid to employees and others, in the same manner as for-profit organizations. These include Forms W-2 and 1099.

d. Reporting Material Changes in the Organization to the IRS

- **Changes to Legal Structure.** Any organization that makes material changes to its legal structure may be required to file a new exemption application to ensure continued qualification for exemption.
- **Amendments to Articles or Bylaws.** If an organization amends its articles of incorporation or bylaws, it should notify the IRS and describe the amendments on its annual Form 990. An organization should submit a copy of amendments to its organizing documents that effect a legal name change with the annual Form 990. Organizations that are not required to file a Form 990 should notify the IRS district director of any such change. The address for notification should appear on the organization’s IRS determination letter.

Chapter 33. Public Disclosure of Exemption Application and Form 990 Returns

a. Information Disclosure

A 501(c)(3) organization must furnish a copy of its Form 1023 exemption application to any person who requests a copy. A limited exemption applies to an organization that filed its application before July 15, 1987, but only if the organization did not have a copy of the application on that date. A 501(c)(3) organization that is a public charity must also furnish copies of its annual IRS Form 990 and Form 990T (UBI return, filed after August 16, 2006) for its three most recent tax years upon request. A public charity is not required to disclose the portion of the return that identifies the names and addresses of contributors to the organization. Certain information may be redacted from the return if the public availability of the information would adversely affect the organization (for example, information that relates to an organization’s trade secret, patent, process or style of work). Similar rules apply to private foundations, except that the contribution list is subject to disclosure.

If the request is made in person, the organization must provide a copy on the day the request is made. In unusual circumstances where this would be unreasonably burdensome, the organization may provide the copy on the next business day. The organization must provide a copy in response to a written request within 30 days.

b. Fees

An organization may charge a reasonable fee for providing copies (currently \$.20 per page) and the actual postage costs. An organization may collect payment in advance of providing the requested copies.

c. Exceptions

A 501(c)(3) organization can avoid the requirement to provide copies by making the necessary documents “widely available.” An organization can make its documents widely available by posting them on the organization’s website or by having the documents posted on another organization’s website as part of a database of similar materials. A limited exception to the disclosure rules also applies to organizations that have been subject to a harassment campaign where a waiver of the rules would be in the public interest.

d. Penalties for Failure to Disclose

A penalty of \$5,000 applies for any failure to provide copies of the required Form 990 returns or the Form 1023 exemption application.

Chapter 34. Documentation of Contributions

For additional information regarding substantiation and disclosure requirements, see Chapter 45 and IRS Publication 1771, Charitable Contributions, at <http://www.irs.gov/pub/irs-pdf/p1771.pdf>, and for issues to consider when fundraising, see Chapters 43-47..

a. Donor Substantiation for All Gifts

In order for a donor to claim a charitable contribution deduction for any gift paid by cash or check, the donor must maintain a record of the gift in the form of a bank record, or a written communication from the charity showing the charity’s name, the date of the contribution and the amount of the contribution.

b. Requirements for Donor: Donations of \$250 or More

In order for a donor to deduct a contribution of \$250 or more, the donor must obtain a written receipt from the recipient charity. The receipt must verify the amount of the contribution and must specifically state whether the charity provided any goods or services, such as a dinner or concert, in consideration for the contribution. If so, the receipt must include a good-faith estimate of the value of the goods or services provided. If the donation consists of property other than cash, the receipt must describe the property. The charitable organization may provide a separate acknowledgment for each contribution or provide donors with an annual or more frequent acknowledgment that sets out the required

information for each contribution of \$250 or more. A canceled check will not satisfy this substantiation requirement.

c. Requirements for Charity: “Quid Pro Quo” Contributions

A charity that receives a payment partly as a contribution and partly as payment for goods or services has received a “quid pro quo” contribution. A charity that receives a quid pro quo contribution in excess of \$75 must provide the donor with a written statement setting out the amount of the payment that is deductible as a contribution. This statement must indicate that the deduction is limited to the excess of the amount of the contribution over the value of the goods or services provided to the donor and must include a “good-faith estimate” of the value of the goods or services. Failure to make this required disclosure can result in penalties of \$10 per contribution, with a total maximum penalty of \$5,000. An exception to the quid pro quo rules may apply if a charity provides only token goods and services, such as mugs or calendars.

d. Sale or Exchange of Donated Property

An individual or entity contributing property to a 501(c)(3) organization and claiming a deduction for more than \$5,000 must obtain an appraisal and report the donation on IRS Form 8283. If the recipient organization disposes of the property within three years after its receipt, the organization must file IRS Form 8282, indicating the property’s sale price, and must provide a copy to the donor.

PART VI. INTERNATIONAL ACTIVITIES AND GRANTMAKING

Chapter 35. Ability of 501(c)(3) Organizations to Carry on Foreign Activities—Non-U.S. Charitable Activities Qualify as 501(c)(3) Activities

A U.S. organization that is otherwise described in § 501(c)(3) of the Code does not jeopardize its 501(c)(3) status even if it accomplishes its exempt activities outside the United States, provided that the foreign activities would have been viewed as charitable within the meaning of Code § 501(c)(3) if they had been carried on in the United States and the conduct of such activities outside the United States does not preclude the organization from qualifying as an exempt organization under that section. Revenue Ruling 71-460, 1972-2 CB 231.

The holding of Revenue Ruling 71-460 is consistent with the position of the IRS in Revenue Ruling 68-165, 1968-1 CB 253, which held that a domestic organization that provides technical and material assistance for self-help projects intended to improve living conditions of the underprivileged and operates a student exchange program qualifies as a 501(c)(3) organization. Similarly, in Private Letter Ruling 200408035 (02/20/2004), the IRS recently confirmed the holding of Revenue Ruling 71-460, stating that a private foundation's proposed grant to the government of an impoverished foreign country to provide housing for residents for the foreign country satisfied the requirement of Code § 501(c)(3). Private Letter Ruling 200121078 (05/29/2001) also reaffirmed the holding of Revenue Ruling 71-460 when it addressed a private foundation's proposed grant to a foreign orphanage.

Chapter 36. Indirect Contributions of Gifts to Be Used Outside the United States—Earmarking

a. Earmarking Issues

Because of the inability of U.S. donors to take an income tax deduction for direct contributions to non-U.S. organizations, and because of the expenditure responsibility rules of § 4945(h) of the Code and the qualifying distribution rules of § 4942 of the Code applicable to private foundations, donors often make contributions to U.S. public charities with the intention that their contributions be used outside the United States. This raises the "earmarking issue."

The question of earmarking arises in situations where the terms and conditions of a donor's gift (i.e., a requirement that the gift be used for a specific beneficiary or be granted to a specific organization) may prevent the recipient organization from controlling the gift. Where a gift is "earmarked" for the ultimate benefit of another organization, the recipient organization is a mere conduit, and the true recipient of the gift is the ultimate beneficiary. In these cases, the tax incidences of the gift must be determined as if the donor directly made the gift to such recipient.

Clearly, the earmarking risk can arise where a donor makes a gift to a U.S. exempt organization with the intention that the gift ultimately be used for a non-U.S. organization. It can also arise in determining whether contributions intended to be used for another recipient

will constitute “public support” for purposes of determining an organization’s public charity status.

b. Revenue Ruling 63-252

Revenue Ruling 63-252, 1963-2 CB 121, sets out the general rule that a donor’s income tax deduction will be disallowed under Code § 170(c) if the donor’s contribution is inevitably committed to a foreign organization and it comes to rest only momentarily in a qualifying U.S. organization. The key question is whether the U.S. organization is the real recipient of the gift because of its right to exercise control over the disposition of the gift. If this control does not exist, the real donee will be the ultimate beneficiary.

The IRS uses five examples to illustrate the general rule of Revenue Ruling 63-252. In the first three examples, the IRS rules that the U.S. recipients were agents of the foreign organizations or conduits, and therefore contributions were earmarked, the U.S. entity was not the recipient of the contribution, and the donors could not deduct their contributions.

- In pursuance of a plan to solicit funds in the United States, a foreign organization formed a domestic organization. At the time of formation, it was proposed that the domestic organization would conduct a fundraising campaign, pay the administrative expenses from the collected fund and remit any balance to the foreign organization.
- Certain persons in the United States, desirous of furthering a foreign organization’s work, formed a charitable organization within the United States. The charter of the domestic organization provides that it will receive contributions and send them, at convenient intervals, to the foreign organization.
- A foreign organization entered into an agreement with a domestic organization which provides that the domestic organization will conduct a fundraising campaign on behalf of the foreign organization. The domestic organization has previously received a ruling that contributions to it are deductible under § 170 of the Code. In conducting the campaign, the domestic organization represents to prospective contributors that the raised funds will go to the foreign organization.

In the final two examples (below) the IRS concluded that the U.S. organizations exercised control over their funds and therefore were the true recipients of the contributions and not mere conduits.

- A domestic organization conducts a variety of charitable activities in a foreign country. Where its purposes can be furthered by granting funds to charitable groups organized in the foreign country, the domestic organization makes such grants for purposes which it has reviewed and approved. The grants are paid from its general funds, and although the organization solicits from the public, no special fund is raised by a solicitation on behalf of particular foreign organizations.

- A domestic organization, which does charitable work in a foreign country, formed a subsidiary in that country to facilitate its operations there. The foreign organization was formed for purposes of administrative convenience, and the domestic organization controls every facet of its operations. In the past the domestic organization solicited contributions for the specific purpose of carrying out its charitable activities in the foreign country, and it will continue to do so in the future. However, following the formation of the foreign subsidiary, the domestic organization will transmit funds it receives for its foreign charitable activities directly to that organization.

c. Revenue Ruling 63-252 and “Friends-of” Organizations

“Friends-of” organizations are U.S. organizations formed to solicit and receive contributions from United States donors and to spend the funds on behalf of a charitable organization outside the United States. An example of a friends-of organization is Americans for Oxford. This organization is a § 501(c)(3) public charity that raises funds in the United States intended to benefit Oxford University in the United Kingdom. U.S. donors to this organization may obtain a U.S. income tax deduction for their contribution, even though the funds are intended to benefit a non-U.S. organization. Americans for Oxford’s website states that its board of directors retains control and discretion concerning grants to Oxford, and although gifts to Americans for Oxford, Inc. must be unrestricted, the board of directors agrees to consider specific preferences of donors.

In Revenue Ruling 63-252, the IRS provided detailed requirements that a friends-of organization must satisfy to ensure that contributions are recognized as made to the U.S. organization (and not the foreign entity) and are therefore deductible. The U.S. organization’s bylaws must provide, in part, that:

- The making of grants and contributions and otherwise rendering financial assistance for the purposes expressed in the charter of the organization shall be within the exclusive power of the board of directors;
- In furtherance of the organization’s purposes, the board of directors shall have power to make grants to any organization organized and operated exclusively for charitable, scientific or educational purposes within the meaning of § 501(c)(3) of the Code;
- The board of directors shall review all requests for funds from other organizations, shall require that such requests specify the use to which the funds will be put, and, if the board of directors approves the request, shall authorize payment of such funds to the approved grantee;
- The board of directors shall require that the grantees furnish a periodic accounting to show that the funds were expended for the purposes which were approved by the board of directors; and

- The board of directors may, in its absolute discretion, refuse to make any grants or contributions or otherwise render financial assistance to or for any or all the purposes for which funds are requested.

The bylaws must provide that the corporation may solicit funds for grants to a specific project or purpose that the board of directors had previously approved. In all events, however, the board of directors must have the right to withdraw approval of the grant and use the funds for other charitable, scientific or educational purposes. The board of directors should communicate to donors that it may at any time withdraw its approval of a particular grant, even after it has been made. The corporation must refuse to accept earmarked contributions that are required in all events to go to the foreign organization.

Commentators have suggested that organizations seeking to qualify as a domestic friends-of-organization (i) include the bylaw provisions described above, (ii) establish grant application review and approval procedures, (iii) adopt the appropriate resolutions for fundraising proposals for each grant and each disbursement, and (iv) require grant accountability. Furthermore, the organization's solicitation materials should ensure that donors understand that they are not giving to the foreign organization and that the domestic organization retains discretion over the use of the gift.

d. Private Foundations and Earmarking Concerns

Private foundations often elect to forego direct contributions to foreign organizations in lieu of making grants to "friends-of" organizations because by making a grant to a U.S. public charity, they avoid the expenditure responsibility requirements of § 4945(h) of the Code and are assured that the grant is a qualifying distribution under § 4942 of the Code. (The expenditure responsibility and qualifying distribution requirements are discussed in further detail in Chapter 38.) The earmarking concerns discussed above apply to grants by private foundations in this type of situation. To obtain the benefits of making a grant to a U.S. public charity, the private foundation's grant must be viewed as made to and received by the U.S. public charity. If the U.S. charity is merely a conduit or an agent for the foreign organization, the private foundation will be considered to have made the gift directly to the foreign organization, and all the complex rules discussed in Chapter 38 will apply to the grant.

Chapter 37. Grants by U.S. Public Charities to Non-U.S. Organizations

As discussed above, a United States public charity may fulfill its qualified exempt purposes by expending funds outside the United States, either by directly carrying on its exempt activities outside the United States or by making grants to individuals or organizations outside the United States that will advance the United States organization's exempt purpose.

If the foreign organization has obtained a favorable determination letter from the IRS regarding its 501(c)(3) status, the U.S. public charity can presume that the recipient will use the contribution for a proper exempt purpose. However, if the foreign organization does not hold a favorable determination letter, the U.S. public charity must establish that the grant was made for an exempt activity, and was in fact, actually used for such purpose, all in

furtherance of the grantor's exempt purpose. Although the detailed procedural requirements imposed on private foundations by the Code and Regulations do not apply to a public charity, the public charity must be able to demonstrate that it has complied with the requirements of Code § 501(c)(3). A U.S. public charity cannot make grants to a foreign organization without exercising sufficient supervision and control to demonstrate compliance with § 501(c)(3) of the Code.

Public charities typically employ written grant agreements to assure that the recipient organizations comply with the requirements described above and that grantees use the grant funds for proper purposes. The grantor often establishes an internal procedure that demonstrates the charity's evaluation of the proposed foreign grant and the manner in which it advances the charity's exempt purposes, establishing controls in the grant arrangement to assure proper use of the funds, and creating reporting obligations from the grantee on its use of the funds. A U.S. charity will need to include provisions in the grant agreement that prevent violation of the requirements of Code § 501(c)(3), such as appropriate restrictions of lobbying and political campaigning activities and that empower the donor to reacquire the funds if used for an improper purpose. It is easier to comply with the requirements of Code § 501(c)(3) if the grant is for a specific project, rather than a general support grant.

Chapter 38. Grants by U.S. Private Foundations to Non-U.S. Organizations

a. Special Rules Applicable to Private Foundations

The Code imposes additional rules on private foundations making grants outside the U.S. These rules include the "expenditure responsibility" provisions of § 4945(h) of the Code and the "qualifying distributions" requirements of § 4942(g) of the Code.

(i) Expenditure Responsibility.

A private foundation's grants to another organization will constitute a "taxable expenditure" under § 4945 of the Code unless the recipient is a public charity or the foundation exercises "expenditure responsibility" with respect to such grant. The following summary conveys the nature of the expenditure responsibility rules of Treasury Regulation § 53.4956-5(b). A granting organization must first perform a pre-grant inquiry into the nature of the grantee, confirming that the grantee will properly use the grant funds. Second, the grantor and grantee must enter into a written grant agreement signed by an officer of the recipient. This agreement must set out a variety of restrictions on the use of the grant, including prohibition on use of the grant for commercial, political or lobbying activities. Treas. Reg. § 53.4945-5(b)(5). The grant agreement must obligate the recipient to provide annual reports to the private foundation and to satisfy certain recordkeeping requirements. Code § 4945(h)(3). Finally, the private foundation itself must satisfy certain recordkeeping requirements with respect to its expenditure responsibility grants and disclose them to the IRS on Form 990-PF.

(ii) Qualifying Distributions.

A qualifying distribution is an amount paid to accomplish one or more of the purposes described in § 170(c)(1) or (c)(2)(B) of the Code, other than a contribution to (1) an

organization controlled by the private foundation or a disqualified person with respect to the private foundation, or (2) a non-operating private foundation. Treas. Reg. § 53.4942(a)-3(a)(2).

A private foundation (other than a private operating foundation) is generally required to make qualifying distributions essentially equal to 5% of its net investment assets. The private foundation will incur an excise tax under § 4942 of the Code if it fails to make the required distribution.

A U.S. private foundation's grant to a foreign organization will generally only constitute a qualifying distribution if the recipient has received a favorable determination from the IRS as to its public charity or private operating status, or the grantor makes a good-faith determination that the foreign organization is the equivalent of a public charity or a private operating foundation (as discussed below).

If the donor private foundation has determined that the foreign recipient is equivalent to a 501(c)(3) entity but cannot determine that it is equivalent to a public charity or private operating foundation, the grant will only constitute a qualifying distribution if it satisfies the "out of corpus" requirements of § 4942(g)(3) of the Code, i.e., the recipient organization must redistribute the grant by the close of the first taxable year after the year of receipt and must provide evidence to the grantor private foundation that a qualifying distribution has been made that is treated under § 4942(h) of the Code as "out of corpus."

(iii) Exceptions.

In certain circumstances an organization will be treated as a public charity for purposes of the expenditure responsibility rules and the qualified distribution rules even though the recipient organization does not possess a determination letter from the IRS finding that it is a public charity. These circumstances are discussed below.

First, a grant to a foreign government or any agency or instrumentality of a foreign government, or an international organization designated as such by Executive Order under 22 U.S.C. § 288 (even if not described in § 501(c)(3) of the Code) that agrees to use the grant exclusively for charitable purposes will constitute a qualifying distribution and will not require expenditure responsibility. Treas. Reg. § 53.4945-5(a)(4)(ii). (Designated international organizations include the United Nations, World Health Organization, and the International Monetary Fund.) A college or university that is an agency or instrumentality of a foreign government or of any political subdivision of a foreign government and that agrees to use the grant exclusively for charitable purposes also comes within this exception. Treas. Reg. § 53.4945-5(a). In these situations it is important that the contributing private foundation make a determination that the recipient organization is a government agency. Private foundations may want to obtain an opinion of counsel or an affidavit of the grantee to confirm that the recipient is a government agency under local law.

Second, a grant to a foreign organization that is "equivalent" to a U.S. public charity will constitute a qualifying distribution and will not require expenditure responsibility. Treas. Reg. § 53.4942(a)-3(a)(6)(i); Treas. Reg. § 53.4945-6(c)(2)(ii); To come within this exception, the donor private foundation must make a good-faith determination that the

foreign organization is “equivalent” to a public charity (the “equivalency test”). The Treasury Regulations provide that a donor organization will have satisfied this requirement if its conclusions are based on an affidavit of the grantee organization or an opinion of counsel that the grantee is an organization described in § 509(a)(1), (2) or (3) of the Code. The opinion or affidavit must set forth sufficient facts concerning the grantee for the IRS to determine that the grantee would be likely to qualify as a organization described in Code § 509(a)(1), (2) or (3).

A private foundation must address two tests to establish that the foreign organization is equivalent to a public charity: (i) the “reasonable judgment test,” which addresses whether the organization is equivalent to a Code § 501(c)(3) entity, and (ii) a “good faith determination test” which evaluates whether the entity is equivalent to a public charity.

To satisfy the reasonable judgment test, the private foundation must determine that the foreign organization is equivalent to a 501(c)(3) entity, i.e., it is organized and operated exclusively for charitable purposes, there is no benefit to private individuals, and it does not carry on prohibited activities (lobbying or political activities). If the foreign organization has received more than 15% of its lifetime support from U.S. sources and has not filed for exemption in the United States, it may not be considered a 501(c)(3) entity. Code § 4948(b); Treas. Reg. § 1.508-1(a)(vi).

To satisfy the good faith determination test, the private foundation must conclude that the entity is equivalent to a public charity under Code § 509(a)(1), (2) or (3) or is an operating private foundation. The private foundation makes this determination by relying on either an opinion of counsel (either counsel to the donor or the recipient) or on an affidavit of the recipient. The opinion or affidavit must provide the same type of information that would be included on a Form 1023 application or a Form 990 return. The array of necessary facts depends upon the type of public charity to which the recipient organization is equivalent. For example, if the foreign organization is equivalent to a Code § 170(b)(1)(A)(vi) organization (“publicly supported”), the recipient needs to demonstrate that it meets the four-year support requirement.

Revenue Procedure 92-94 establishes a procedure whereby the U.S. grantee may rely on a current qualified affidavit in making the equivalency determination for both the expenditure responsibility and the qualifying distribution requirement. Typically, a current qualified affidavit provides information for the entity’s latest complete accounting year and other current data. If the recipient’s public charity status depends on demonstrating adequate public support, the grant must provide a statement containing sufficient financial data to establish that it continues to meet the applicable Code provision. Rev. Proc. 92-94 § 4.04, 1992-2 CB 507. A private foundation cannot rely on an affidavit if it possesses information that suggests the affidavit may not be reliable. Furthermore, the grantor cannot rely on an affidavit if the public charity status is based on public support and the donor’s grant will cause the organization to fail the support test.

b. Grantor's Duty to Inquire as to Code § 501(c)(3) Status of Foreign Organization Lacking Determination Letter

Based on a letter from the IRS to the Council on Foundations dated June 18, 2001, a private foundation does not need to establish that a foreign charitable organization is equivalent to either a public charity or a private foundation. It may simply treat the foreign organization as a noncharitable entity to which it makes grants for charitable uses. In this situation, the private foundation must exercise expenditure responsibility with respect to the grant and require the recipient to hold the grant funds in a segregated account dedicated to the exempt purpose of the grant. If the private foundation takes these steps, the grant will constitute a qualifying distribution under § 4942 of the Code and will not be a taxable expenditure under Treasury Regulation § 53.4945-6(c). This approach contrasts with a situation in which the donor private foundation finds that the foreign charitable organization is equivalent to a 501(c)(3) organization but that it is NOT equivalent to a public charity. Here, the grantor would still have to exercise expenditure responsibility and the grant would avoid taxable expenditure status under Code § 4945. However, the grant will not constitute a qualifying distribution under Code § 4942 unless the recipient satisfied the "out of corpus" rules discussed above.

Chapter 39. Special Treatment Accorded Canadian and Mexican Organizations

a. Canada

The U.S.-Canada Income Tax Treaty provides for reciprocal recognition of exemption for religious, scientific, literary, educational or charitable organizations. Article XXI of the treaty exempts a Canadian or U.S. charity from income tax in the other country, and it allows a limited charitable contribution deduction for gifts by U.S. citizens or residents to Canadian charities and by Canadian residents to U.S. charities.

Notice 99-47, dated September 7, 1999, states that recognized religious, scientific, literary, educational or charitable entities that are organized under the laws of either the United States or Canada will automatically receive recognition of exemption without application in the other country. Thus, U.S. organizations must be recognized as exempt under § 501(c)(3) of the Code to come within this agreement, and Revenue Canada must recognize Canadian organizations as Canadian registered charities. Every Canadian registered charity is automatically treated as a 501(c)(3) organization, regardless of whether the entity has filed a Form 1023 with the IRS. The Canadian entity's 501(c)(3) status will continue until the United States decides that the organization is not exempt.

It is important to note that under this arrangement there is a presumption that all registered Canadian charities are private foundations for U.S. tax purposes, unless they demonstrate otherwise. This presumption can create qualifying distribution issues for U.S. private foundations that make grants to Canadian registered charities if the private foundation cannot determine that the recipient is equivalent to a public charity.

b. Mexico

The U.S.-Mexico Income Tax Treaty (the "treaty") also provides for reciprocal recognition of exemption and reciprocal deduction of charitable contributions. Article 22(1) of the treaty provides for mutual recognition of income tax exemptions for the two countries' qualified charities. Article 17(a) of the 1992 protocol relating to the U.S.-Mexico treaty provides that an organization treated as exempt in one country will be treated as exempt in the other country.

Under the treaty, a U.S. or Mexican contributor making a cross-border contribution to a charity in the other country may deduct the contribution in the state of residence because in Article 17(b) of the 1992 protocol, the two countries agreed that Article 70-B of the Mexican Income Tax Law and §§ 509(a)(1) and 509(a)(2) of the Code (other than churches or a convention or association of churches as described in § 170(b)(1)(A)(i) of the Code) provide essentially equivalent standards as contemplated by Articles 22(2) and 22(3) of the treaty. Entities qualifying under Mexican law will be treated as public charities for U.S. purposes, and unlike the U.S.-Canada treaty, there is no need for an entity-by-entity determination of public charity status for U.S. purposes.

In Information Letter 2003-0158, the IRS concluded that a U.S. private foundation or other grantmaker may rely on the provisions of Article 22 of the treaty and Paragraph 17 of the protocol and treat an Article 70-B Mexican charity as equivalent to a 501(c)(3) organization classified as a public charity described in § 509(a)(1) or § 509(a)(2) of the Code (except for an organization described in § 170(b)(1)(A)(i) of the Code (churches and conventions or associations of churches)).

Chapter 40. Consequences to Foreign Recipients of Grants (Withholding Issues for Grantor)

The Code imposes U.S. tax on certain kinds of U.S. source income. Sections 871(a)(1) and 881(a) of the Code impose a 30% tax on several types of U.S.-source nonbusiness income of nonresident aliens and foreign corporations. Section 1441(a) of the Code generally provides that the person making a payment that constitutes gross income from sources within the United States to a nonresident alien must withhold tax at a rate of 30% at the time the payment is made. However, in the case of scholarship or fellowship payments made to individuals in the United States on an F, J, M or Q immigration status, the withholding rate may be reduced to 14%. Code § 1441(b); Rev. Proc. 88-24, 1988-1 CB 800. In addition, the withholding rate may be reduced or eliminated by treaty.

Under the withholding rules discussed above, U.S. grantors are generally required to withhold U.S. tax on the nonexempt portion of scholarship and fellowship grants to foreign students for study in the United States Code § 117 excludes from the recipient's income scholarships or fellowship grants used for tuition, fees and books. However, grants used for other purposes, such as room and board, are not excluded from income. Likewise, amounts received for services performed for the grantee (teaching or research activities) are taxable, even though these services may be required to obtain a degree or the scholarship.

In general, scholarships and fellowship grants (as defined in Code § 117), grants (as defined in Code § 4942(g)), and prizes and awards (as defined in Code § 74) made by a U.S. charity for study in the United States are treated as income from sources within the United States. Treas. Reg. § 1.863-1(d)(2)(i). Conversely, scholarships, fellowship grants, targeted grants and achievement awards to foreign recipients studying outside the United States are treated as sourced outside the United States and are not subject to U.S. tax. Treas. Reg. § 1.863-1(d)(2)(ii). Amounts paid as salaries or compensation are governed by the sourcing rules applicable to personal services under Treasury Regulation § 1.861-4.

In January 1, 2001, the IRS issued Treasury Regulations under § 1441 of the Code that broadly defined the type of income subject to 30% withholding. The IRS has indicated that reimbursement for travel and living expenses of independent contractors is included in the type of gross income (as emoluments or remunerations) subject to withholding under Code § 1441(a). *See* 98 TNT 246-14 (General Information Letter dated December 16, 1998). These facts have created uncertainty with respect to withholding by U.S. charities on grants solely for travel expenses of a grantee doing research, attending conferences or otherwise performing activities in the United States. The Council on Foundations has requested that the IRS provide guidance on the final regulations under § 1441 with respect to grants solely for travel expenses of a grantee who is doing research, attending conferences, or otherwise performing activities in the United States. The June 14, 2002 letter to the IRS requesting this guidance, and a supporting detailed memorandum are published in 37 Exempt Org. Tax Rev. 370 (2002). As of the present time, the IRS has not provided guidance on this point.

Chapter 41. Compliance With Antiterrorist Provisions

a. Executive Order 13224

In response to the terrorist attacks on the United States of September 11, 2001, President Bush issued Executive Order 13224 to cut off resources to terrorists and terrorist organizations by blocking assets. This order prohibits transactions with individuals and organizations associated with terrorism and blocks any assets controlled by or in the possession of such entities and those supporting them. While the Executive Order is not a law, it has the force of law.

The Executive Order expressly prohibits donations to certain persons and organization (i.e., “Listed Persons”). Listed Persons include individuals and organizations identified by the Executive Order, by the Secretary of State, and by the Secretary of the Treasury. Listed Persons can also include other parties who assist, sponsor or support acts of terrorism by Listed Persons or are otherwise associated with Listed Persons.

Several U.S. government agencies, the United Nations and the European Union have created lists of known or suspected terrorists. The Treasury Department’s Office of Foreign Assets Control (“OFAC”) maintains the most comprehensive U.S. list, which can be found at <http://www.treas.gov/offices/enforcement/ofac/sdn/>. OFAC operates a listserv that provides an electronic notice whenever the list is altered. The listserv is at <http://www.treas.gov/press/email/subscribe.html>. Other lists include the U.S. Government’s Terrorist Exclusion List maintained by the Department of Justice at <http://www.state.gov/s/ct/rls/other/des/123086.htm>, the European Union’s list at

<http://www.statewatch.org/news/2004/jun/01terrlists.htm>, and the U.N.'s list at <http://www.un.org/Docs/sc/committees/1267/pdflist.pdf>. Note that the Executive Order can extend to persons that are not actually included in the published lists due to a person's relationship with one who is on a published list.

The Executive Order has neither a knowledge nor an intent requirement, and thus an organization can violate the Executive Order (and have its assets frozen) even if it does not know that it is supporting a Listed Person and does not intend to support a Listed Person. In contrast, the USA Patriot Act (discussed below) does have a knowledge and intent requirement.

The reach of the Executive Order is quite broad. It applies to all U.S. persons regardless of their location. Prohibited types of transactions include financial support, in-kind support, material assistance and technical assistance. Exec. Order No. 13,224 § 1(d). Prohibited transactions also include humanitarian donations (including food, clothing and medicine) to Listed Persons. Exec. Order No. 13224, § 4.

b. USA Patriot Act

The USA PATRIOT Act (the "USA Patriot Act") was enacted into law on October 26, 2001 and reauthorized in 2005. While the USA Patriot Act includes a variety of anti-terrorism provisions, the ones that most impact nonprofits and grantmakers are those that expand penalties for providing material or financial support for terrorism. It is clear that the penalty provisions of the USA Patriot Act (both criminal and civil) apply to nonprofits, and commentators anticipate that investigation and enforcement activities may focus on exempt organizations involved in international grantmaking or that directly carry out international programs.

(i) Material Support for Terrorism.

With enactment of the USA Patriot Act, federal law imposes fines and terms of imprisonment of up to 15 years for any entity that provides material support or resources knowing or intending that they are to be used in terrorist acts or by a Foreign Terrorist Organization ("FTO"). Penalties includes life imprisonment if the terrorism results in death.

(ii) Financing Terrorism.

The federal crime of financing terrorism was added in June 2002. This law punishes an individual or organization that willfully provides or collects funds with the intention that such funds be used to carry out acts of terrorism or who knowingly conceals the source of funds used to carry out terrorism or to support FTOs. Terrorist Bombings Convention Implementation Act of 2002 § 202(a), 18 U.S.C. § 2339C.

(iii) Potential Civil Penalties.

The USA Patriot Act created a specific civil cause of action for private parties against those who provide material support for terrorism. Under this law, a successful private plaintiff may recover treble damages, court costs and attorneys' fees. 18 U.S.C. § 2333(a). A

civil plaintiff may proceed as soon as it can allege the basic elements necessary to prove civil harm and need not wait for a criminal indictment or conviction.

c. Voluntary Treasury Guidelines

On September 29, 2006, the Treasury Department issued an updated version of the U.S. Department of the Treasury Anti-Terrorist Financing Guidelines: Voluntary Best Practices for U.S.-Based Charities (the “Voluntary Treasury Guidelines”), available at <http://treas.gov/press/releases/hp122.htm>. The Voluntary Treasury Guidelines do not have the force of law, and an exempt organization is not obligated to comply with these guidelines. Furthermore, the Voluntary Treasury Guidelines do not create a “safe harbor.” The Treasury Department suggests that an exempt organization following these guidelines will reduce the chance that it will unwittingly make problematic expenditures or that it will be found liable if it does make problematic expenditures.

The Voluntary Treasury Guidelines address five topics. The first four address (i) fundamental principles of good charitable practice, (ii) governance accountability and transparency, (iii) financial accountability and transparency, and (iv) programmatic verification. The suggestions in these first four topics are typically practiced by most well-run nonprofits.

The fifth topic of the revised Voluntary Treasury Guidelines speaks to anti-terrorist financing best practices and has generated more controversy. In drafting the revised guidelines, the Treasury Department responded to various comments it had received regarding the initial version. Many of these comments were critical of the initial draft of the Voluntary Treasury Guidelines. For example, the Council on Foundations stated that the initial version of the Voluntary Treasury Guidelines (i) were not tailored to the reality of international grantmaking by U.S. charitable organizations, (ii) did not take into account either the legal requirements governing international grants or the extensive experience of U.S. grantmakers in administering foreign grant funds, and (iii) included provisions that are unworkable in many respects, are wholly unrelated to achieving the intended objectives, and have a compliance cost so high as to deter many charitable organizations from making international grants. *See* Council on Foundations, Comments on U.S. Department of the Treasury Anti-Terrorist Financing Guidelines: Voluntary Best Practices for U.S.-Based Charities, June 20, 2003, (http://www.cof.org/files/Documents/Legal/Treasury_Comments_06.03.pdf). However, the Treasury Department rejected many of the suggestions included in the comments.

The suggested anti-terrorist procedures require collecting extensive information about the potential recipient, and the grantor would need to demonstrate that it has (i) collected certain basic information about a grantee; (ii) conducted basic vetting of grantees, including a reasonable search of publicly available information to determine whether the foreign recipient organization is or has been suspected of activity relating to terrorism, including terrorist financing or other support, and to determine that the grantee and its key staff are not on the OFAC list or subject to OFAC sanctions, and (iii) conducted basic vetting of its own key employees, including a reasonable search of publicly available sources to determine whether they are suspected of activities relating to terrorism or are subject to OFAC sanctions. Furthermore, if a charity’s vetting practice leads to a finding that any of its own

key employees, any of its grantees, or any of the key employees of grantees is suspected of terrorism activities, the Voluntary Treasury Guidelines direct the charity to take certain actions.

Chapter 42. Best Practices

At the present time, grantmakers do not possess any “official” guidance from the Treasury Department to aid in developing compliance plans and procedures that will satisfy the requirements of Executive Order 13224, the USA Patriot Act, and other laws. As discussed above, the Voluntary Treasury Guidelines are simply that, voluntary. Moreover, they can generate significant burdens on grantmakers, especially smaller organizations, and are expensive to carry out. Finally, there is no assurance that a grantmaker complying with the Voluntary Treasury Guidelines will avoid violating the law.

**PART VII. FUNDRAISING:
THE OBVIOUS AND NOT-SO-OBVIOUS PITFALLS**

Chapter 43. Charitable Solicitation in Washington

a. Generally

Charitable Solicitation in Washington is governed by the Charitable Solicitations Act (“CSA”), Chapter 19.09 RCW, and the Consumer Protection Act (“CPA”), Chapter 19.86 RCW. The CSA is a specific statute that regulates charitable solicitations and the organizations that conduct charitable solicitations. The CSA regulates the activities of persons and entities that raise money—or say they raise money—from the public for charitable purposes. The CPA is a statute of general applicability that protects consumers from unfair or deceptive acts or practices in trade or commerce, which includes unfair or deceptive acts or practices in the context of charitable solicitations. Violations of the CSA are per se violations of the CPA. A person or entity that violates the CSA may face a civil action alleging violations of both statutes.

The purpose of this Chapter is to set forth the most prominent fundraising requirements for charitable organizations in the state of Washington. This Chapter is not a complete statement of the law regarding charitable organizations or solicitation activities (including its application to other organizations and individuals), nor is it a substitute for seeking the advice of an attorney regarding any legal questions you may have.

Many other states have similar regulations, which should be reviewed carefully before you undertake charitable solicitations outside Washington.

b. Overview of the Charitable Solicitations Act

The CSA regulates charitable organizations so as to provide information to the public about charitable organizations that engage in fundraising in order to prevent deceptive and dishonest practices and the improper use of contributions that are intended for charitable purposes. The CSA regulates charitable organizations and commercial fundraisers. It requires these organizations to (1) register and file annual reports with the Secretary of State, and (2) make certain disclosures when soliciting for charitable contributions. The CSA also prohibits fundraisers and commercial co-venturers from misleading consumers.

c. Regulation of Charitable Organizations Under the CSA

(i) Definition of “Charitable Organization”

The CSA defines “charitable organization” as an entity that solicits or collects contributions from the general public where the contribution is purported to be for a charitable purpose. A “charitable organization” does not include commercial fundraisers, commercial co-venturers, or fundraising counsel. RCW 19.09.020(2). Churches and their integrated auxiliaries also are not charitable organizations, but they must comply with RCW 19.09.100(12), (15), and (18). RCW 19.09.020(2) (these statutory provisions bar deceptive solicitations, require that anyone soliciting on behalf of another organization must be sure the other organization is properly registered, and forbid any form of harassment of donors and

potential donors). Religious organizations that are not churches or their integrated auxiliaries are charitable organizations. RCW 19.09.020(15). The CSA broadly defines “charitable purpose.” The definition includes, but is not limited to, the generally accepted meaning of assisting the poor and the needy—it also includes educational, environmental, religious, literary, recreational, social, patriotic, legal defense, benevolent, and humanitarian purposes. RCW 19.09.020(3).

Here are some examples of charitable organizations and of entities that are not charitable organizations under the CSA:

- Any individual or entity that solicits charitable contributions from the public is a charitable organization. This includes for-profit businesses or loose associations of people. It also includes firefighters’ unions that ask members of the public to purchase tickets to an event to benefit their members.
- Organizations that raise money for charitable causes from the public and donate all of the money to those causes are not charitable organizations if they do not solicit charitable contributions from the public.
- An organization that solicits contributions only from its members is not a charitable organization if membership in the organization is determined by the payment of dues, fees, or other assessments that confer bona fide rights, privileges, professional standing or other direct benefits, in addition to the right to vote, hold office, or elect officers. “Membership” does not include those who become members of the organization upon making a contribution as a result of a solicitation.
- Organizations that maintain websites or send email messages that solicit or accept charitable contributions from Washington residents are charitable organizations. However, some passive website holders may not constitute charitable organizations for purposes of the CSA if it is obvious that the appeal for charitable contributions is not directed to Washington residents.

(ii) Definition of “Solicitation”

The CSA defines “solicitation” as (1) any appeal for a contribution from the general public where there is an appeal for a charitable cause or a charitable purpose; and (2) any offer to sell goods or services where an appeal is made for a charitable cause or purpose, the name of a charitable organization is used to help make the sale, or if it is stated or implied that all or part of the sales proceeds will benefit a charitable cause or purpose. RCW 19.09.020(18).

Here are some examples of what constitutes a charitable solicitation and what does not:

- A telephone call in which the caller says, “Please buy a ticket to the Peter Frampton concert to benefit disadvantaged youths,” is a charitable solicitation.
- A letter that asks for a contribution to the United Way is a charitable solicitation.

- A website that describes a program to help homeless people find work and explains how to make a donation is a charitable solicitation.
- A postcard asking for donations of used clothing and household items to benefit the disabled is a charitable solicitation.
- Grant applications are not charitable solicitations. WAC 434-120-025(22)(e)(i).
- Bingo, raffles, and amusement games regulated by the Gambling Commission are not charitable solicitations. WAC 434-120-025(22)(e)(ii).
- Sales of goods or services that constitute the basis for the charitable organization's activities for which tax-exempt status was granted, such as Seattle Repertory Theatre's ticket sales, are not charitable solicitations. WAC 434-120-025(22)(e)(iii).

(iii) Registration and Reporting Requirements.

All charitable organizations must register with the Secretary of State unless they are exempt from the CSA. RCW 19.09.065. Exempt organizations are (1) charitable organizations that raise less than \$25,000, if the organization's fundraising activities are conducted exclusively by volunteers (no commercial fundraisers) and none of the officers or members receive compensation in any form (including distribution of assets) from the organization, RCW 19.09.076; WAC 434-120-100(c); (2) political organizations; and (3) individuals or entities that appeal for funds on behalf of specific individuals named in the solicitation only if all of the proceeds of the solicitation are given to or expended for the direct benefit of the named individual, RCW 19.09.076.

Charitable organizations must provide the information requested by the Secretary of State. Among other things, they must report financial information, including revenue and the total amount applied to charitable purposes, costs, and expenses, and solicitation information. RCW 19.09.075; WAC 434-120-103, -105.

All charitable organizations must register before conducting solicitations. Charitable organizations must renew their registrations and file reports annually. Conducting solicitations without current registration is a violation of the CSA and may result in legal action. RCW 19.09.065.

d. Regulation of Commercial Fundraisers Under the CSA

A "commercial fundraiser" is a person or entity in the business of conducting charitable solicitations on behalf of others in exchange for compensation or other consideration. RCW 19.09.020(5).

"Fundraising counsel" or "consultants" are not commercial fundraisers. "Fundraising counsel" or "consultants" are retained by charitable organizations under written contract to provide services such as advice and counseling regarding charitable solicitation activities, and do not engage in any fundraising activities on behalf of others. RCW 19.09.020(10).

Commercial fundraisers must register and file reports annually with the Secretary of State using the required forms.

Commercial fundraisers must file information pertaining to the charitable organizations with which they contract, financial information regarding the total value of the contributions received, and solicitation information. RCW 19.09.079; WAC 434-120-200, -215.

A commercial fundraiser must post a bond of at least \$15,000 and file a copy of the bond with the Secretary of State, if it meets one of the four following criteria: (1) the commercial fundraiser directly or indirectly receives contributions from the public on behalf of a charitable organization; (2) the commercial fundraiser is compensated based on the amount of funds raised or the amount to be raised, on the number of solicitations made or to be made, or on a similar method; (3) the commercial fundraiser incurs or is authorized to incur expenses on behalf of a charitable organization; or (4) the commercial fundraiser had not been registered with the Secretary of State in the last accounting year. RCW 19.09.190.

Commercial fundraisers must register before conducting any charitable solicitations. They must renew on an annual basis.

e. Contracts Between Charitable Organizations and Commercial Fundraisers

The CSA requires written contracts between charitable organization and commercial fundraisers. RCW 19.09.097. The contract must be filed with the Secretary of State before the commercial fundraiser commences solicitation activities on behalf of the charitable organization. The contract must contain the following provisions:

- A requirement that both parties must comply with the law.
- A provision that allows the officers of the charitable organization (1) reasonable access to the fundraiser's financial records pertaining to the charitable organization, (2) the ability to be present during telephone solicitations, and (3) the names of all of the commercial fundraiser's employees or staff who are conducting the solicitations.
- A statement of the amount of funds that the charitable organization will receive or the method of computing the amount, the commercial fundraiser's compensation or the method of computing that amount, and whether the compensation is fixed or contingent.

f. Solicitation Requirements

The CSA applies broadly to appeals for support of charitable organizations or causes as commonly defined; there are a few specific exceptions, discussed below. "Solicitation" in this context refers to any form of request for a contribution or donation, including most invitations to become a "member" or "supporter" of an organization or cause. Therefore, anyone making a solicitation (including formally organized groups and ad hoc efforts) must

comply with the solicitations rules regardless of whether they must register with the Secretary of State.

There are several provisions of the CSA that do not apply to churches and their affiliate auxiliaries; however, they must comply with RCW 19.09.100(12), (15) and (18) (see below).

When making a solicitation, the solicitor must disclose the following:

- The name of the individual who is making the solicitation;
- The name of the charitable organization and the city of its principal place of business; and
- If requested by the solicited person, the Secretary of State's toll-free number (1-800-332-GIVE).

If the solicitation is by telephone, the disclosures must be made during the solicitation but before asking for a commitment of a contribution, and in writing to any solicited person that makes a pledge within five working days of the pledge. If the solicitor sends any written material before the contribution is received, the disclosures must be made in that written material. RCW 19.09.100(3).

Commercial fundraisers making a solicitation must disclose the following:

- The name of the individual making the solicitation;
- The full name of the commercial fundraiser;
- The name of the charitable organization and the city of its principal place of business; and
- If requested by the solicited person, the Secretary of State's toll-free number (1-800-332-GIVE).

Disclosures required in solicitations by advertisement or mass distribution (e.g., posters, brochures, publications, audio or visual broadcasts, automatic dialing devices) include:

- The solicitation is conducted by a commercial fundraiser, if it is;
- The notice of solicitation is on file with the Secretary of State; and
- Additional information can be obtained by calling the Secretary of State's toll-free number (1-800-332-GIVE). RCW 19.09.100(4).

Anyone using a vending machine or container to solicit must make these disclosures:

- The name of the charitable organization for which the funds are solicited;
- The name, business address, and telephone number of the individual and fundraiser responsible for collecting the funds in the containers or vending machines; and
- This statement: “This charity currently is registered with the secretary’s office under the charitable solicitations act, registration number” RCW 19.09.100(5).

Organizations whose names are similar to government entities are required to make these additional disclosures:

- Whether the organization is or is not part of any government unit; and
- The true nature of its relationship with the government unit. RCW 19.09.100(8).

g. Prohibited Representations

The CSA prohibits the following representations:

1. That a solicited contribution is tax deductible unless the charitable organization has received tax-exempt status from the IRS. RCW 19.09.100(7).
2. That the person conducting the solicitation is a volunteer or words of similar meaning or effect that create the impression that the person soliciting is not a paid solicitor unless that person is not paid for his or her services. RCW 19.09.100(7).
3. That the person conducting the solicitation is a member, staff member, helper, or employee of the charitable organization or words of similar effect that create the impression that the person is not a paid solicitor if the person is employed, connected, or paid by a commercial fundraiser. RCW 19.09.100(7).
4. Any statement that is false, misleading, or deceptive. All solicitations, advertising material, and promotional plans must fully and fairly disclose the identity of the entity on whose behalf the solicitation is made. RCW 19.09.100(12).
5. A commercial fundraiser shall not represent that tickets to any fundraising event will be donated for use by another person unless all of the following requirements are met:
 - a. The commercial fundraiser has a written commitment from people stating that they will accept the donated tickets and the number they will accept;

- b. The commercial fundraiser retains the written commitments for three years and makes them available to the Secretary of State, Attorney General, or county prosecutor on demand;
- c. The contributions solicited for donated tickets do not exceed the amount representing the number of ticket commitments on file; and
- d. The commercial fundraiser gives all of the tickets to the people who made the written commitments to receive them no later than seven calendar days prior to the ticketed event. RCW 19.09.100(6).

h. Prohibited Conduct

The CSA also prohibits the following conduct as part of charitable solicitation:

- Using the words “police,” “sheriff,” “firefighter,” or similar words in a solicitation unless the highest ranking official in a bona fide police, sheriff or firefighter department or organization has authorized that use in writing. RCW 19.09.100(9).
- Using the name of a nationally known or federally chartered military veterans’ service organization in a solicitation unless the highest ranking official of that organization in Washington State has authorized that use in writing. RCW 19.09.100(10).
- Leading the public to believe that registration with the Secretary of State constitutes state endorsement or approval of the charitable organization or the solicitation activities. RCW 19.09.100(14).
- Harassing, intimidating, or tormenting conduct during a telephone solicitation. RCW 19.09.100(18).
- Making a telephone solicitation before 8:00 a.m. or after 9:00 p.m. Pacific time. RCW 19.09.100(17).
- Failing to comply with Chapter 19.09 RCW or local regulations regarding charitable solicitation. RCW 19.09.100(11).
- Soliciting on behalf of any charitable organization or for any commercial fundraiser that is not registered with the Secretary of State, unless the organization is exempt from registration. RCW 19.09.100(15).
- Soliciting on behalf of a charitable organization or for a commercial fundraiser that has been, or whose officers, directors, or principals have been, convicted of a crime involving charitable solicitations in any state or foreign country within the past ten years, or subject to a permanent injunction, administrative order, or judgment pursuant to RCW 19.09.080 or .090 within the past ten years. RCW 19.09.100(13).

i. Record Keeping

The CSA requires that all charitable organizations and commercial fundraisers maintain accurate books and records at their business location. The records must be retained for three years after the period for which they relate expires. Contracts between charitable organizations and commercial fundraisers must be maintained for three years after the period to which they relate expires. RCW 19.09.200.

Charitable organizations, or commercial fundraisers who solicit on their behalf, must keep records of the following contributors for three years following the contributions:

- Each contributing entity that collects individual contributions from an employee or member group or a business and turns them over to a charitable organization as a single sum.
- Each corporation that contributed.
- Each individual who contributed more than \$25. WAC 434-120-135.

All records, contracts, and contributor lists must be made available to the attorney general or the county prosecutor upon demand.

Commercial fundraisers must submit financial statements to the Secretary of State, attorney general, or county prosecutor upon demand. The statements shall include, without limitation:

- The gross amount of the contributions pledged and the gross amount collected.
- The amount retained by the commercial fundraiser and the amount given or to be given to charitable organizations and the details of distribution.
- The aggregate amount paid and to be paid for solicitation expenses.
- The amounts paid and to be paid to charitable organizations.
- Copies of annual reports. WAC 434-120-255.

j. The Consumer Protection Act

As stated above, the CPA prohibits unfair and deceptive acts or practices. RCW 19.86.020. The CPA applies to fundraising activity regardless of whether the activity is covered by the CSA, if the activity is in trade or commerce. Violations of the CSA are per se violations of the CPA. RCW 19.09.340.

Under the CPA, the attorney general may bring an action to enjoin unfair or deceptive acts or practices, including acts prohibited by the CSA. The court may award civil penalties of up to \$2,000 per violation. The court may award attorneys' fees to the prevailing party.

RCW 19.86.080. A private litigant may also bring an action under the CPA to enjoin unfair or deceptive acts or practices and, in addition, the court may award treble damages. The court may award attorneys' fees to the prevailing party. RCW 19.86.090.

Chapter 44. Nonprofit Bulk Mailing Permits

Many nonprofit organizations qualify to use nonprofit standard mail (which used to be called "bulk" mail) to send certain kinds of announcements at reduced cost. Under United States Postal Service rules, the organization must qualify to use these preferential rates and maintain its eligibility each year and each mailing must be suitable as nonprofit standard mail.

Nonprofit Standard Mail Eligibility (Publication 417) has detailed instructions about applying for authorization to mail at nonprofit rates and the kinds of mail that can be sent under such authorization; the Postal Service uses the word "entry" to describe the process of submitting mail for it to handle and deliver. Copies are available through local post offices and from the Business Mail Entry office of the Postal Service at 4735 East Marginal Way S., Suite 1113, Seattle, Washington 98134-9651, (206) 652-2200 or (800) 364-3815. It is also available (in .pdf format) on the Postal Service website at <http://pe.usps.gov/cpim/ftp/pubs/Pub417/Pub417.pdf>.

a. How to Apply

To apply for authorization to mail at nonprofit rates, use PS Form 3624. A blank form is included in Publication 417. Once the authorization is granted, a fee must be paid and arrangements made to pay the postage for mailings. There are several options: special stamps, postage metering, or use of a deposit account from which the Postal Service will deduct the postage charges for each mailing as it occurs. The details are explained in Postal Service publications.

Not every organization that may be recognized as tax-exempt by the IRS under § 501 is eligible to use nonprofit mail. Generally, auto clubs, business leagues, chambers of commerce, citizens and civic improvement associations, service clubs, social and hobby clubs and trade associations will not be accepted as nonprofit mailers. There are also some sorts of organizations, particularly political groups and voting registration offices, that are specifically authorized to use nonprofit standard mail.

b. How to Complete a Nonprofit Mailing

Nonprofit standard mailings must be delivered to a Postal Service Bulk Mail Acceptance facility. The minimum size of a mailing is 200 pieces or 50 pounds. The pieces to be mailed must be sorted and bundled following very specific procedures. The postage rate that will be applied to the mailing will depend on the kind of sorting that has been done by the mailer. Lower rates are available for mailings when the pieces are "automation ready" by virtue of having Postal Service bar codes imprinted near the addresses from an address file that has been screened as the post office requires. Several Quick Service Guides outline these requirements; they can be obtained from Business Centers or on the Internet. Current rates for different kinds of mailings are shown on the current versions of PS Form 3602 N for

occasional mailings and 3541 N for periodicals—these forms are known as Postage Statements and are used to calculate the postage due at the time of mailing.

Many nonprofit organizations rely on mailing houses to prepare bulk mailings to these specifications. Their services range from simply sorting, bundling and delivering to the post office to comprehensive consultation about the design and strategy of a continuing mailing program. They are listed in the Yellow Pages under “Mailing Services.”

When nonprofit standard mail is presented for mailing at the Bulk Mail facility, a Postal Service employee will review the Postage Statement, examine the items to be mailed, and check to see if the postage charge is proper. The mailing will not be accepted if anything is amiss in any of these areas. Errors on the Postage Statement can usually be corrected immediately. If the review of the items to be mailed suggests that they are not eligible to be mailed at nonprofit rates, it is possible to agree to pay the higher rate in order to have the mailing go out immediately and appeal the extra charges later through an administrative process. If the mail is marked with a Nonprofit Mailing Permit number (called “nonprofit indicia” by the Postal Service) and the deposit account balance is not sufficient to cover the mailing, the facility may agree to hold it while a deposit is made.

c. Troubleshooting

There are many features of mailings that may make them ineligible for mailing at nonprofit rates. Common problems include:

- Items that are not identical. It is best to check in advance with the post office when there will be any variation from piece to piece.
- Use of an organization’s permit to attempt a mailing for another organization that has not received authorization.
- Problems with “cooperative mailings,” or arrangements whereby more than one organization is sharing in the costs, risks, or benefits. Such an arrangement is only possible when all the cooperating organizations are authorized to mail at nonprofit rates and (unless special arrangements have been made) at the same post office.
- The mailing includes words such as “sponsored by” that suggest that some organization other than the authorized nonprofit mailer will benefit directly from the distribution of the materials being mailed.
- The mailing contains promotional mention of travel, credit card, insurance or certain other goods or services.

There are different requirements for periodical mailings (which generally may contain advertising without loss of nonprofit eligibility). Considerations are discussed in useful detail in Publication 417.

The practice of using postage-paid reply envelopes or cards is covered by a separate set of regulations and standards. There are no special provisions for nonprofit organizations in the area of business-reply mail.

The Postal Service will review the content of planned mailings while they are in preparation. If you anticipate difficulties at the time of mailing, you can contact a Business Mail Entry office for assistance. If there are any areas of concern that remain after consulting with the Postal Service, request that the results of the prescreening of your proposed mailing be sent in the form of a letter.

The Postal Service sends announcements and other information to authorized nonprofit mailers from time to time. It also conducts occasional training and information sessions and participates in meetings for mailers and other interested parties. Once an organization has been authorized to mail at nonprofit rates, these informational mailings and invitations will be sent automatically.

Chapter 45. Requirements for Deducting Contributions

A charitable contribution is deductible by the donor only if the donor and the donee organization follow certain verification procedures. While the majority of the burden to “substantiate” a charitable contribution falls on the donor, the donee organization has certain responsibilities of its own under the substantiation rules. This Chapter addresses the following topics: (a) proving the donee organization is qualified to receive deductible contributions; (b) the substantiation requirements for donors; (c) the “contemporaneous acknowledgment” requirement for donee organizations; (d) the “quid pro quo contribution” disclosure requirement for donee organizations; (e) the information return filing requirement for donee organizations selling contributed property within three years of receipt; and (f) gifts of vehicles. The discussion of these issues is based in substantial part on Boris Bittker & Lawrence Lokken, *Federal Taxation of Income, Estates and Gifts* § 35.5 (3d ed. 2003).

NOTE: The substantiation requirements discussed below currently apply only to the income tax charitable deduction; there are currently no comparable requirements for the gift or estate tax charitable deductions. For those purposes, the donor or executor must submit such information as may be requested by the IRS. See Treas. Reg. §§ 25.2522(a)-1(c), 20.2055-1(c). Regulations proposed in 1988 but not yet finalized state that trusts and estates asserting a Code § 642(c) deduction in lieu of a deduction under Code § 170(a) are to be allowed such deduction if they satisfy the substantiation requirements of Treas. Reg. §1.170A-13. See Prop. Reg. §§ 1.642(c)-1, -2.

a. Proving Donee Organization Is Qualified

A taxpayer claiming a charitable deduction has the burden of establishing that the donee organization is qualified to receive deductible contributions. Rather than compel donors to rely on the organization’s statements or to prove independently that it is a qualified recipient, the IRS issues a Cumulative List of Exempt Organizations (IRS Publication 78,

issued periodically), which is kept current by notices in the weekly *Internal Revenue Bulletin*. Contributions made on or before the date notice of the revocation of an organization's exempt status is published in the *Internal Revenue Bulletin* may be deducted unless the donor knew of the revocation, was aware that it was imminent, or was either responsible for or aware of the activities resulting in the organization's loss of qualification. *See Rev. Proc. 82-39, 1982-2 C.B. 759.*

If an organization seeks review of an IRS revocation of its exempt status under the declaratory judgment procedures of Code § 7428, contributions to the organization during the pendency of the proceeding are generally deductible, regardless of the outcome and regardless of whether the donor knows of the revocation or of the activities that led to it. *See Code § 7428(c).* This protection, however, is not allowed for more than \$1,000 of gifts by any one donor (with husband and wife treated as one contributor). Moreover, if the organization loses in the declaratory judgment proceeding, the deduction is denied for donations made during the pendency of the proceeding by any person who was responsible for the activities or failures to act that caused the revocation.

If an organization has not received an IRS ruling confirming its tax-exempt status, the deductibility of contributions to the organization depends on when the donee was organized. If it was organized before October 10, 1969, the donor may establish that the organization satisfies the requirements of Code § 170(c), a showing that can call for detailed analysis of the organization's charter, bylaws, and activities. *See S. Rep. No. 552, 91st Cong., 2d Sess., reprinted in 1969-3 C.B. 459.* If the donee was organized after October 9, 1969:

- The organization is not a Code § 501(c)(3) organization unless it gives notice of its application for recognition of exempt status (*see Code § 508(a)(1)*);
- If notice is not given within 15 months after organization, exempt status is not recognized for any period before the notice is given (*see Code § 508(a)(2)*); and
- No deduction is allowed for gifts or bequests made while the organization is not exempt (*see Code § 508(d)(2)(B)*).

In contrast, if timely notice is given and the organization is qualified, contributions are deductible, even if the contribution is made before the notice.

The foregoing rules thus require would-be exempt organizations organized after October 9, 1969, to call the IRS's attention to their existence and to the status they claim. The effect of the notice is procedural rather than substantive, and the action taken by the IRS on the application is not conclusive. Nevertheless, a favorable ruling is of great practical importance because it reassures potential donors and, unless revoked, relieves them of the need to prove independently that the organization is a qualified recipient of deductible contributions. The notice requirement does not apply to:

- Churches and certain related organizations;

- Organizations, other than private foundations, that do not normally have gross receipts in excess of \$5,000 per taxable year; and
- Subordinate organizations, other than private foundations, covered by a group exemption letter.

b. Requirements for Donors

(i) Statement Describing Property

An individual, partnership, or corporation is allowed no deduction for a charitable gift claimed to exceed \$500 unless (i) the donor's return for the year during which the gift was made includes a description of the property and such other information as the IRS may require, or (ii) the donor shows that the failure to include this statement was "due to reasonable cause and not to willful neglect." *See* Code §§ 170(f)(11)(A)(i), 170(f)(11)(A)(ii)(II), 170(f)(11)(B). For purposes of the dollar threshold, all similar items of property donated to one or more organizations are treated as one property. *See* Code § 170(f)(11)(F).

This requirement applies to a C corporation only if it is either a personal service corporation or a closely held C corporation. *See* Code §§ 170(f)(11)(A)(i), 170(f)(11)(B). With respect to a gift by a partnership or S corporation, the partnership or corporation must include a statement with its return, but if the statement is not so included, the deduction is denied at the partner or shareholder level. *See* Code § 170(f)(11)(G).

(ii) Appraisal Requirement

Generally, an individual, partnership, or corporation is allowed no deduction for a charitable contribution claimed to exceed \$5,000 unless the donor obtains a qualified appraisal of the property and the donor's return for the taxable year during which the contribution was made includes such information regarding the property and the appraisal as the IRS may require. *See* Code § 170(f)(11)(C). If the claimed deduction exceeds \$500,000, the donor's return must include a copy of the qualified appraisal. *See* Code § 170(f)(11)(D). These requirements apply to a C corporation whether or not it is a personal service corporation or closely held corporation. They do not, however, apply to gifts of cash, inventory property, and publicly traded securities or to gifts of vehicles, which are governed by different rules described below. *See* Code § 170(f)(11)(A)(ii)(I). Also, a taxpayer failing to meet the requirements may salvage the deduction by showing that the failure is due to reasonable cause and not to willful neglect. *See* Code § 170(f)(11)(A)(ii)(II).

For purposes of the appraisal requirements, including the \$5,000 and \$500,000 thresholds, all similar items of property donated to one or more organizations shall be treated as one property. *See* Code § 170(f)(11)(F). With respect to a gift by a partnership or S corporation, the requirements apply at the entity level, but if they are not satisfied, the deduction is denied at the partner or shareholder level.

A qualified appraisal is an appraisal satisfying requirements established by the Treasury or IRS. *See* Code § 170(f)(11)(E). An appraisal is qualified if it meets four requirements. *See* Treas. Reg. § 1.170A-13(c)(3)(i).

- First, it must be made not earlier than 60 days before the gift or later than the due date (with extensions) of the return on which the deduction is claimed.
- Second, it must be made by a “qualified appraiser,” who must sign and date the appraisal report. To be qualified, an appraiser must declare in the report that he or she:
 - Performs appraisals regularly or holds himself or herself out to the public as an appraiser;
 - Is qualified to appraise property of the type involved;
 - Is not the donor, the donee, the person from whom the donor acquired the property, or a person employed by or related to any of the foregoing; and
 - Understands that an intentionally false or fraudulent appraisal subjects him or her to penalties.
- Third, a qualified appraisal must be embodied in a report that contains several items of information. *See* Treas. Reg. § 1.170A-13(c)(3)(ii).
 - The report must describe the property sufficiently so that a person other than an expert can tell that the property appraised is the donated property.
 - If the property is tangible, the report must describe its physical condition.
 - Any agreement or understanding limiting the donee’s use of the property must be described.
 - The report must state the appraiser’s name, address, and taxpayer identification number, describe the appraiser’s qualifications, and note the date of the appraisal and the date (or expected date) of the taxpayer’s gift.
 - The report must state the property’s fair market value on the date of the gift and describe the valuation method or methods used in determining that value and the facts used in applying that method.

- Fourth, an appraisal is not qualified if the appraiser receives a fee calculated as a percentage of the donated property's value or a fee that may vary with the amount allowed as a charitable deduction. *See* Treas. Reg. § 1.170A-13(c)(6).

Generally, a separate qualified appraisal is required for each item of property. *See* Treas. Reg. § 1.170A-13(c)(3)(iv)(A). However, if a taxpayer makes two or more gifts of similar items of property to one or more organizations within a taxable year, one appraisal may cover all of these gifts. A donor must obtain an appraisal not later than the due date (with extensions) of the return on which the deduction for the gift is claimed. *See* Treas. Reg. § 1.170A-13(c)(3)(iv)(B). A taxpayer must retain an appraisal for so long as it may be relevant in the administration of any internal revenue law. *See* Treas. Reg. § 1.170A-13(c)(3)(iv)(C).

c. Acknowledgment Requirement for Donee Organizations

A contribution of \$250 or more is not deductible unless the taxpayer substantiates the contribution by a contemporaneous written acknowledgment of the contribution by the donee organization. *See* Code § 170(f)(8)(A). If the taxpayer gives \$250 or more to an organization more than once during a particular year, the deduction for gifts may be substantiated by one acknowledgment covering all of the gifts or by a separate acknowledgment for each gift. *See* Treas. Reg. § 1.170A-13(f)(1). The \$250 threshold applies separately to separate gifts, and no contemporaneous acknowledgment is required for separate contributions of less than \$250 each, even if the sum of the taxpayer's contributions to the donee organization during the taxable year equals \$250 or more. *See id.*

If the donor's payment is distributed to another charity, the initial payee is usually treated as the donee for this purpose, even if the ultimate recipient of the funds is designated by the taxpayer. *See* Treas. Reg. § 1.170A-13(f)(12). However, if the ultimate recipient provides goods or services to the taxpayer and the payment is put through the intermediate charity in an attempt to avoid a reduction of the taxpayer's deduction for the value of the goods or services, the gift is deemed made to the ultimate recipient, not the intermediate charity.

The contemporaneous acknowledgment must state the amount of a cash contribution and provide a description, but not a valuation, of donated property other than cash. *See* Code § 170(f)(8)(B). It must also state whether the donee organization provided any goods or services in consideration for the contribution and, if so, it must include a description and good faith estimate of the value of these goods or services. However, no contemporaneous acknowledgment is required if, after subtracting the value of the goods and services, the charitable gift is less than \$250. *See* Treas. Reg. § 1.170A-13(f)(1).

If the donee organization provides any intangible religious benefits, the acknowledgment must contain a statement to that effect. *See* Code § 170(f)(8)(B)(iii). An "intangible religious benefit" is a benefit provided by an organization organized exclusively for religious purposes that generally is not sold in a commercial transaction outside the donative context. *See* Code § 170(f)(8)(B). An example is admission to a religious ceremony. *See* H.R. Rep. No. 213, 103d Cong., 1st Sess. 566. Tuition for education leading to a

recognized degree, travel services, and consumer goods are not intangible religious benefits unless they are *de minimis* and incidental to a religious ceremony (e.g., communion wine). *See id.* at n.34.

The acknowledgment need not contain the donor's taxpayer identification number. *See* H.R. Rep. No. 213, 103d Cong., 1st Sess. 565 n.30. No particular form is required, and the acknowledgment may consist, for example, of a letter, postcard, or computer-generated form. *See id.* at n.32. An acknowledgment is contemporaneous if the taxpayer obtains it no later than the date on which the taxpayer's return for the year is filed or, if earlier, the filing due date, taking extensions into account. *See* Code § 170(f)(8)(C).

For a taxpayer performing gratuitous services for charity, unreimbursed expenses incident to these services are considered adequately substantiated if the taxpayer's records adequately substantiate the amount of the expenses and the charity provides a written statement:

- Describing the taxpayer's services;
- Stating whether the organization provided any goods or services in consideration for the unreimbursed expenses and, if so, providing a good faith estimate of the value of the goods or services; and
- Stating whether the organization provided any intangible religious benefits for the taxpayer. *See* Treas. Reg. § 1.170A-13(f)(10).

If payments to charity are made by withholding from the taxpayer's salary or wages, the amount withheld from each payment of wages is a separate contribution for purposes of the \$250 threshold. *See* Treas. Reg. § 1.170A-13(f)(11). If the amount withheld for any pay period is \$250 or more, the gift is adequately substantiated by (i) a pay stub or Form W-2 from the employer stating the amount withheld and the recipient of the withheld amount, and (ii) a pledge card or other document prepared by or at the direction of the donee organization stating that the organization provides no goods or services in consideration for contributions made by payroll deduction.

A contribution by a partnership or S corporation is treated as made by the entity, not its partners or shareholders, who are allowed the deduction for the gift. *See* Treas. Reg. § 1.170A-13(f)(15). The entity must therefore obtain contemporaneous acknowledgment for a gift of \$250 or more, even if no partner's or shareholder's share of the gift is as much as \$250, and a partner or shareholder whose share of the gift is \$250 or more is not required to substantiate the gift further.

The contemporaneous acknowledgment requirement is waived if the donee organization files a return including the information required to be given by the acknowledgment. *See* Code § 170(f)(8)(D). Also, the Treasury, by regulations, may waive some or all of the requirements of the acknowledgment rule in appropriate cases. *See* Code § 170(f)(8)(E).

d. Quid Pro Quo Contribution Requirement for Donee Organizations

The recipient of a quid pro quo contribution in excess of \$75 must provide a written statement to the donor in connection with the solicitation or receipt of the contribution. *See* Code § 6115(a). The term “quid pro quo contribution” generally includes any payment made partly as a contribution and partly in consideration for goods or services provided to the donor by the donee organization. *See* Code § 6115(b). However, a contribution to a religious organization is not quid pro quo if the donor receives solely an intangible religious benefit that generally is not sold in a commercial transaction outside the donative context. Also, no statement is required for a gift to the federal government or a state or local government if the gift is exclusively for public purposes. *See* Code § 6115(a). Moreover, transactions that have no donative element (e.g., sales of goods by a museum gift shop that are not, in part, donations) are not quid pro quo contributions. *See* H.R. Rep. 213, 103d Cong., 1st Sess. 566. The \$75 threshold is applied separately to each contribution. *See id.* at n.36.

The statement required must inform the donor that the federal income tax deduction for the contribution is limited to the amount of the contribution (the sum of the money and the fair market value of any contributed property), less the value of the goods or services provided by the organization. *See* Code § 6115(a)(1). It must also provide a good faith estimate of the value of such goods or services. *See* Code § 6115(a)(2).

The organization may estimate fair market value by any reasonable method, so long as the method is applied in good faith. *See* Treas. Reg. § 1.6115-1(a)(1). If the goods or services are not generally available in a commercial transaction, their value may be estimated by reference to the fair market value of similar or comparable goods or services, even if those goods or services do not have the unique qualities of the goods or services that are being valued. *See* Treas. Reg. § 1.6115-1(a)(2).

Various goods and services, including many items of smaller value and most benefits allowed to members who pay annual membership contributions of \$75 or less, may be disregarded in determining whether a contribution is quid pro quo and, if so, in valuing goods or services. *See* Treas. Reg. § 1.6115-1(b). These items are also disregarded if they are provided to employees or partners of a corporate or partnership donor. *See* Treas. Reg. § 1.6115-1(d)(1). If a donor to a college or university is given the right to purchase tickets at athletic events, this right is arbitrarily valued at 20% of the amount of the contribution. *See* Code § 170(l).

The statement need not be in any particular form, but the disclosure must be made in a manner that is reasonably likely to come to the attention of the donor. *See* H.R. Rep. No. 213, 103d Cong., 1st Sess. 566 n.35. A disclosure of the required information in small print set forth within a larger document might not meet the requirement.

A penalty of \$10 is usually imposed for each quid pro quo contribution for which the required written statement is not provided. *See* Code § 6714(a). The penalties will apply if an organization either fails to make any disclosure in connection with a quid pro quo contribution or makes a disclosure that is incomplete or inaccurate. *See* H.R. Rep. No. 213, 103d Cong., 1st Sess. 566. However, the aggregate penalty for a particular fundraising event

or mailing may not exceed \$5,000, and the penalty is excused for a contribution if the failure to provide the statement is due to reasonable cause. *See* Code § 6714(a), (b).

A donor receiving a quid pro quo contribution can generally rely on a written acknowledgment provided by the charity in valuing the charitable gift, but a donor must disregard the charity's valuation if the donor knows, or has reason to know, that such treatment is unreasonable. *See* Treas. Reg. § 1.170A-1(h)(4).

e. Information Return Requirement for Donee Organizations Selling Contributed Property Within Three Years of Receipt

If a recipient of charitable deduction property sells, exchanges, or otherwise disposes of the property within three years after receiving it, it must file an information return showing:

- The donor's name, address, and taxpayer identification number;
- A description of the property;
- The date of the contribution;
- The amount received on the disposition;
- The date of such disposition;
- A description of the donee's use of the property; and
- A statement indicating whether the use of the property was related to the purpose or function constituting the basis for the donee's exemption under Code § 501. *See* Code § 6050L(a)(1).

“Charitable deduction property” is property other than money for which a donor claimed a charitable deduction based on a claimed value that, when added to the claimed value of all similar items of property donated by the donor to one or more donees, exceeds \$5,000. *See* Code § 6050L(a)(2)(A). Publicly traded securities for which market quotations were readily available on an established securities market when the contribution was made are not charitable deduction property and are disregarded in applying the \$5,000 threshold. *See* Code § 6050L(a)(2)(B). The donee must furnish a copy of the return to the donor. *See* Code § 6050L(c).

If the original donee transfers the property to another charitable organization within three years, the original donee should provide a copy of its report on the transfer to the successor donee, and the successor donee should also report any disposition it makes within three years after the original gift. *See* Treas. Reg. § 1.6050L-1(c). The return is due 125 days after a disposition triggering the obligation to file. *See* Treas. Reg. § 1.6050L-1(f). The information return is excused in three situations:

- First, it need not be filed if the gift is of money or publicly traded securities or if, for some other reason, the donee is not required to sign an appraisal summary under the donor substantiation rules described above. *See* Treas. Reg. § 1.6050L-1(e).
- Second, no return is required to report the sale of an item if the donor attests in the appraisal summary that the item’s appraised value does not exceed \$500. *See* Treas. Reg. § 1.6050L-1(a)(2).
- Third, the return need not be filed if the property is consumed by the donee in the pursuit of its charitable purposes. *See* Treas. Reg. § 1.6050L-1(a)(3).

f. Gifts of Vehicles

If the claimed value of a charitable gift of a qualified vehicle exceeds \$500, no deduction is allowed for the gift unless the donor substantiates it with a contemporaneous written acknowledgment from the donee organization and includes the acknowledgment with the return on which the deduction is claimed. Even if so substantiated, the deduction may not exceed the donee’s gross proceeds on selling the vehicle unless the donee uses the vehicle in its charitable activities or materially improves it. *See* Code § 170(f)(12).

(i) Qualified Vehicles

A “qualified vehicle” is a motor vehicle manufactured primarily for use on public streets, roads, and highways, a boat, or an airplane. *See* Code § 170(f)(12)(E). While the rules apply to donations of new as well as used vehicles, they do not apply to a donor that held a donated vehicle as inventory or for sale to customers in the ordinary course of business.

(ii) Vehicles Sold Without Significant Intervening Use or Material Improvement

If a donee organization receiving a charitable gift of a qualified vehicle sells it without making any significant intervening use or material improvement of the vehicle and realizes gross sales proceeds exceeding \$500, the donor’s deduction for the gift is the lesser of the gross proceeds or the vehicle’s fair market value at the time of the gift, provided all other requirements of Code § 170 are satisfied. *See* Code § 170(f)(12)(A)(ii). If the gross sales proceeds are \$500 or less, the donor’s deduction is the lesser of the vehicle’s fair market value when contributed or \$500. *See* Notice 2005-44, 2005-25 I.R.B. 1287, § 4.02.

(iii) Vehicles Significantly Used or Materially Improved

The rule limiting the deduction for a charitable gift of a qualified vehicle to the gross proceeds on the donee organization’s sale does not apply if the donee significantly uses or materially improves the vehicle before selling it. *See* Code § 170(f)(12)(A)(ii). If properly substantiated, the deduction for such a contribution equals the vehicle’s fair market value when donated.

To meet the significant use test, an organization must actually use the vehicle to substantially further the organization’s regularly conducted activities, and the use must be

significant. A donee organization will not be considered to significantly use a qualified vehicle if the use is incidental or not intended at the time of the contribution. Whether a use is significant also depends on the frequency and duration of use. *See* Notice 2005-44, 2005-25 I.R.B. 1287, § 7.01(1).

Material improvements include major repairs to a vehicle, or other improvements to the vehicle that improve the condition of the vehicle in a manner that significantly increases the vehicle's value, but not cleaning, minor repairs, or routine maintenance. *See id.* § 7.01(2). Services not qualifying as material improvements include painting, waxing, rustproofing, applications of other finishes, removal of dents and scratches, repair of upholstery, and installation of theft deterrent devices. *See id.* Moreover, an improvement funded by an additional payment to the donee organization from the donor of the qualified vehicle cannot be a material improvement, regardless of its nature.

(iv) Vehicles Transferred to Needy Individuals

The rule limiting the deduction to the gross proceeds on a donee organization's sale without significant use or material improvement does not apply if the donee sells a qualified vehicle to a needy individual at a price significantly below fair market value or makes a gift of the vehicle to such an individual in direct furtherance of a charitable purpose of the donee organization of relieving the poor and distressed or the underprivileged who are in need of a means of transportation. *See id.* § 3.02(3). The charitable purpose must be served by making vehicles available to the sellers or transferees; it is not sufficient that the charity uses the proceeds of sales to help needy individuals for charitable purposes. *See id.*

(v) Fair Market Value

The fair market value of a qualified vehicle, like that of any other property, is the price at which the property would change hands between a willing buyer and a willing seller, neither being under a compulsion to buy or sell and each having reasonable knowledge of relevant facts. *See* Treas. Reg. § 1.170A-1(c)(2). An established used vehicle pricing guide establishes a particular vehicle's value only if it lists a sales price for a vehicle that is the same make, model, and year, sold in the same area, in the same condition, with the same or substantially similar options or accessories, and with the same or substantially similar warranties or guarantees, as the vehicle in question. *See* Notice 2005-44, 2005-25 I.R.B. 1287, § 5. A donor of a qualified vehicle must obtain a qualified appraisal if his or her deduction is not limited to the gross proceeds of the donee organization's sale of the vehicle and is claimed to exceed \$5,000. *See id.* § 6.

(vi) Acknowledgments

For a gift of a vehicle with a claimed value exceeding \$500, the donee organization's acknowledgment must include the donor's name and taxpayer identification number, the vehicle identification number of the donated vehicle, and the date of the contribution. *See* Code § 170(f)(12)(B). If the donee sells the vehicle without a significant intervening use or material improvement, the acknowledgment must also certify that the vehicle was sold in an arm's length transaction between unrelated parties, indicate the date and gross proceeds of the sale, and state that the donor's deduction may not exceed the gross sale proceeds. *See*

Code § 170(f)(12)(B)(iii). If the donee intends to use or improve the vehicle, the acknowledgment must include a certification and detailed description of the intended use or improvement, the intended duration of such a use, and a certification that the vehicle will not be sold before the use or improvement is completed. *See* Code § 170(f)(12)(B)(iv). If the donee intends to sell or give the vehicle to a needy person at a price significantly below fair market value in direct furtherance of a charitable purpose, the acknowledgment must also certify that the donee will make such a sale or gift and that the sale or gift will directly further the organization's charitable purpose of relieving poor and distressed or underprivileged persons in need of means of transportation. *See* Notice 2005-44, 2005-25 I.R.B. 1287, § 3.03(4).

An acknowledgment must be "contemporaneous." A donee organization satisfies this requirement by providing an acknowledgment within 30 days after its sells a vehicle at fair market value or, if the acknowledgment certifies an intended use, improvement, or sale or gift to a needy person, within 30 days after the contribution is made. *See* Code § 170(f)(12)(C). A donee organization must provide the information contained in an acknowledgment to the IRS. *See* Code § 170(f)(12)(D). An organization may provide an acknowledgment in any reasonable manner. *See* Notice 2005-44, 2005-25 I.R.B. 1287, § 8.03. A donee must report contributions of qualified vehicles to the IRS on Form 1098-C and may use copies of this form as contemporaneous written acknowledgments to donors.

(vii) Penalties for False or Fraudulent Acknowledgments

The IRS may impose a penalty on a donee organization required to furnish a contemporaneous written acknowledgment to a donor of a qualified vehicle if the organization knowingly furnishes a false or fraudulent acknowledgment or knowingly fails to furnish such acknowledgment in the manner, at the time, and showing the information required by the foregoing rules. *See* Code § 6720. For each vehicle that the donee organization sells without significant intervening use or material improvement, the penalty for a false or fraudulent acknowledgment, no acknowledgment, or a noncompliant acknowledgment is the greater of the gross sale proceeds or 35% of the sales price stated in the acknowledgment. *See* Code § 6720(1). If a donee organization does not so sell a vehicle, the penalty for a false or fraudulent acknowledgment is the greater of 35% of the claimed value of the vehicle or \$5,000. *See* Code § 6720(2).

Chapter 46. Fundraising Involving Gambling

All gambling in Washington State is subject to regulation by the Washington State Gambling Commission (and in certain circumstances to control by tribal governments). The Internet address for the Gambling Commission is <http://www.wsgc.wa.gov/>. The Gambling Commission permits some sorts of gambling to occur without special licensing and has established specific licensing procedures that can be used by nonprofit organizations that wish to offer gambling activities to the public as a form of fundraising.

The forms of gambling that can occur without a license are described and limitations or restrictions are listed in the Gambling Commission's pamphlet "Unlicensed Gambling Activities" (<http://www.wsgc.wa.gov/newsletters/5-204.pdf>). Only certain authorized charitable and nonprofit organizations are permitted to host or organize several forms of

unlicensed gambling activity. An authorized organization must have at least 15 members who have the right to elect members of the board, it must have been in operation for at least 12 months prior to the gambling event or activity, and it must be able to show that it has made “significant progress toward achieving [its] stated purposes” during the preceding 12 months. The permitted activities include bingo; raffles and amusement games; raffles for members only; turkey shoots; golfing sweepstakes; card and dice games and limited social card games – all of which are defined and described in the pamphlet mentioned above. In most cases, the total receipts from such activities cannot exceed \$5,000 per year, and participation is often restricted to members of the organization or members and their guests.

All other gambling activities require a license. The Revised Code of Washington states that gambling activities for “the raising of funds for the promotion of bona fide charitable or nonprofit organizations is in the public interest” when conducted as authorized by the law. RCW 9.46.010. Accordingly, charitable and nonprofit organizations may apply for a license to engage in various sorts of gambling for fundraising purposes. As with unlicensed gambling activities discussed above, organizations seeking a license for gambling activities must have at least 15 members with the right to elect members of the board, and there are many further requirements. A document presenting the consolidated regulations for nonprofit gambling as a fundraiser can be found at <http://www.wsgc.wa.gov/forms/apps/4-090-Rules.pdf>.

There are also federal tax considerations that require attention before an exempt-organization embarks on any program that includes gambling. A useful summary is in IRS Publication 3079, which can be found at <http://www.irs.gov/pub/irs-pdf/p3079.pdf>.

In 2004, the Gambling Commission published *Charitable and Nonprofit Gambling in Washington State*, a comprehensive report by consultant Sally Perkins. See http://www.wsgc.wa.gov/docs/npg_report/np_gambling_report.asp. The report summarized the trends in charitable and nonprofit gambling in Washington and examined the factors contributing to the various kinds of difficulties experienced by nonprofits that conduct gambling activities as a form of fundraising. One conclusion stated in the report:

The charitable/nonprofit gambling sector has steadily declined. Many organizations have stopped participating in C/NP gambling activities and the total number of licensees has dropped significantly since 1987. Even though gross receipts and net income have increased steadily in Raffles, there have been larger declines in Bingo and [Punch Boards and Pull Tabs]. Thus, the entire sector’s gross receipts are down 36% from its best year in 1994 compared to 2003 (\$321 million to \$206 million).

This research also found that the expenses of operating the gambling activity often amount to more than half of the sponsoring organization’s total expenditures (“This raises the question of the primary purpose of the organization—gambling or programs”) and that several large organizations experienced six-figure losses in total operations (gambling and nongambling combined) in recent years.

The headquarters of the Gambling Commission is at 4565 7th Avenue S.E., Lacey, WA 98503; the postal address is P.O. Box 42400, Olympia, WA 98504-2400 (800-345-2529 or 360-486-3440).

There are regional offices in Everett (425-304-6300), Kennewick (509-734-7412 or 509-734-7465), Port Orchard (360-769-9113), Renton (425-277-7014), Spokane (509-325-7900), Tacoma (253-671-6280), Toledo (360-864-4240), Vancouver (360-833-0587), Wenatchee (509-886-6228, 509-886-6229 or 509-886-6230) and Yakima (509-575-2820).

Chapter 47. Alcoholic Beverages at Fundraising Events

Everything to do with alcoholic beverages in Washington is regulated by the Liquor Control Board. Many nonprofit organizations host events at which liquor is served. At times, nonprofits also include alcoholic beverages among the items sold at fundraising auctions or offered as raffle prizes. Before doing any of these things, organizations should carefully review current Liquor Board rules. The address for the Washington State Liquor Control Board's website is <http://www.liq.wa.gov/>.

Serving liquor, or organizing events where liquor is served, can expose an organization to specific forms of risk. Before planning a party or any other activity involving liquor, an organization should check insurance policies carefully to make sure they cover or can be extended to cover all of the risks that may arise. Venues where alcoholic beverages are going to be served may also require evidence of adequate insurance and impose (or be required to impose) other conditions.

One very common sort of event is a reception or other occasion hosted by a nonprofit organization at which alcoholic beverages are available to the attendees. Under certain circumstances, such events may be held using a "banquet permit." From the Liquor Board's website, http://www.liq.wa.gov/licensing/ap_process.aspx:

A banquet permit is for a private, invitation only event (not open or advertised to the public). The liquor must be provided free of charge, or brought by individuals attending the event. Package deals are allowed that may include, for example, the cost of dinner, liquor, and entertainment. To assure participants receive an equal share, tickets exchangeable for drinks may be issued as part of the package price. No separate or additional charge may be made for liquor. You can get a banquet permit for \$10 at any local liquor store or agency.

A banquet permit is always required for events of this sort. If a nonprofit organization is helping to put on the event, or will benefit in some way from the program, a banquet permit is necessary even if the invitations are issued in the names of individuals (board members or key fundraising volunteers, for example).

Nonprofit organizations can also get Special Occasion Licenses for fundraising and other events. The Liquor Board's website (see link above) explains:

A special occasion license allows a nonprofit organization to sell liquor at a specified date and place. All proceeds from the sale of liquor must go directly back into the nonprofit organization.

The fee for a special occasion license is \$60 per day, per location and allows sales of spirits, beer and wine by individual serving for on-premise consumption. Special occasion licenses are limited to 12 single-day events per calendar year. The organization should apply 45 days before the fundraising events. You can pick up a special occasion license application at any local liquor store or agency, or contact the customer service desk at (360) 664-1600.

There are several other kinds of alcoholic beverage licenses that may be of interest to some organizations. Each requires an application and annual renewals; there is introductory information about the application process on the Liquor Control Board's website. These summaries are from http://www.liq.wa.gov/licensing/license_fees.aspx:

Nonprofit Arts Organization—\$250. Allows a nonprofit arts organization which sponsors and presents artistic or cultural performances to sell spirits, beer, and wine to patrons for consumption on the premises.

Private Club - Beer and Wine—\$180. To sell beer and/or wine for on-premises consumption. Beer and wine may be sold either on tap or in opened bottles or cans. Private Club licensees may not sell beer or wine for off-premises consumption.

Private Club - Spirits, Beer, and Wine—\$720. To sell spirits, beer, and wine by the individual serving for on-premises consumption. Beer and wine may be sold either on tap or in opened bottles or cans. Private Club licensees may not sell beer or wine for off-premises consumption. (Non-Club Event Endorsement—\$900. Allows up to 40 non-club, member-sponsored events annually using club liquor).

The Washington State Liquor Control Board has published pamphlets and guides on these and other topics that are available on request.

The Washington State Liquor Control Board office is located at 3000 Pacific Avenue S.E., Olympia, WA 98504-3080. The postal address is P.O. Box 43075, Olympia, WA 98504-3075, and email can be sent to WSLCB@liq.wa.gov. Customer service by telephone: (360) 664-1600. Many application forms and other Washington State Liquor Control Board materials can be obtained from any Washington State Liquor Control Board store. There are also enforcement offices, where suspected infractions or other concerns may be reported, in many locations across the state; they are listed at http://www.liq.wa.gov/EnforcementOfficeInfo/enforce_office.aspx.

PART VIII. WASHINGTON STATE TAXES AND NONPROFIT CORPORATIONS

Chapter 48. Nonprofit Organizations Are Subject to State Taxes

In Washington State, nonprofit organizations are presumed taxable in the same manner as for-profit organizations. Therefore, if no statutory exemption or deduction exists, a nonprofit organization must pay, to the extent applicable, each of the following taxes: (i) state and local business taxes, (ii) state and local retail sales taxes, (iii) state and local use taxes, and (iv) real and personal property taxes.

The general presumption in favor of taxation means that while a nonprofit organization should assume that all its business activities are taxable, it should also determine whether a specific exemption or deduction applies to the specific activity or transaction. A nonprofit organization claiming any exemption or deduction has the burden of proof of establishing that it qualifies for the benefit or deduction.

Chapter 49. The State Business and Occupation Tax

a. Defined

Washington imposes the business and occupation tax (“B&O tax”) on the gross receipts of every person engaged in business activities in the State. Thus, a nonprofit organization must pay the B&O tax based the value of its products, the gross proceeds of its sales, or the gross income of its services, as appropriate. Typically, nonprofit organizations pay tax under at least two general classifications of the B&O tax. These classifications are (i) retailing and (ii) service and other activities.

(i) Retailing.

Retailing includes every sale of tangible personal property to consumers (e.g., sales of publications, periodicals, books and tapes). Retailing also includes certain services such as repair or improvement of property and certain personal services such as health and fitness activities. Nonprofit organizations must pay a tax, currently at a rate of 0.471% of the organization’s gross sales proceeds from such activities. Because the retail sales tax uses this same definition as a starting point, sales of property or services in this category are also subject to the retail sales tax.

(ii) Service and Other Activities.

The service and other activities category includes all other sources of income that do not fall into another B&O tax category. Nonprofit organizations must pay a tax, currently at a rate of 1.5% of the gross income the organization receives from such taxable items as services, rents, fees, advertising income, dues, reimbursements, agency fees, and commissions. Unlike retailing, items in this category are not subject to the retail sales tax.

b. Exemptions for Low Gross Receipts and the Small Business Tax Credit

(i) Low Gross Receipts.

Nonprofit organizations are not required to register with the Washington State Department of Revenue or pay the B&O tax if their gross annual receipts are \$12,000 or less and the organization is not required to pay any other State tax such as the sales or use tax.

(ii) The Small Business Tax Credit.

The small business tax credit may offset all or a portion of the B&O tax. For example, a nonprofit organization that reports in the service and other activities classification will pay no B&O tax if its gross receipts are \$28,000 or less on an annual basis. This credit, however, applies only to the B&O tax due from the organization and does not apply to any retail sales and use taxes due.

c. Exemptions and Deductions for Artistic and Cultural Organizations

Washington exempts certain nonprofit organizations from liability for the B&O tax.

Artistic and cultural organizations may deduct from their B&O tax liability all their income from business activities.

Artistic or cultural organizations include nonprofit corporations that are organized and operated exclusively for the purpose of providing “artistic or cultural exhibitions, presentations, or performances or cultural or art education programs” for viewing or attendance by the general public. The term “artistic or cultural exhibitions, presentations, or performances or cultural or art education programs” includes and is limited to:

- An exhibition or presentation of works of art or objects of cultural or historical significance, such as those commonly displayed in art or history museums;
- A musical or dramatic performance or series of performances; or
- An educational seminar or program, or series of such programs, offered by the organization to the general public on an artistic, cultural, or historical subject.

To qualify for the permitted deduction, a nonprofit corporation must meet the following requirements:

- The organization must be either (i) a nonprofit corporation organized and managed by a governing board of not less than eight individuals, none of whom is a paid employee of the corporation or (ii) a corporation sole;
- No part of the corporation’s income may be paid directly or indirectly to its members, stockholders, officers, directors or trustees, except in the form of

services rendered by the corporation in accordance with its purposes and bylaws;

- Salary or compensation paid to the corporation's officers and executives must be only for actual services rendered, and at levels comparable to the salary or compensation of like positions within the state;
- Assets of the corporation must be irrevocably dedicated to the activities for which the exemption is granted and, upon liquidation, dissolution, or abandonment by the corporation, may not inure directly or indirectly to the benefit of any member or individual, except a nonprofit organization, association, or corporation which would also be entitled to the exemption;
- The corporation must be duly licensed or certified when licensing or certification is required by law or regulation;
- The amounts received that qualify for exemption must be used for the activities for which the exemption is granted;
- Services must be available regardless of race, color, national origin or ancestry; and
- The Department of Revenue must have access to the corporation's books to determine whether the corporation should be exempt.

Requirements Concerning Boards

The most problematic area is the first requirement: at least eight board members, none of whom is a paid employee. This means no member of the board of directors may be a paid employee, regardless of the number of directors. For example, an organization with 39 board members, five of whom are paid employees, would not qualify for the deduction. Similarly, if the executive director, a paid employee, is directly involved in the decision making or management by the board of directors, no deduction is applicable. However, if the executive director serves the board in an advisory capacity, without voting rights, a deduction is allowed. Cautious nonprofit organizations that qualify for this deduction may want to ensure that the organization's articles call for at least eight directors and provide that the executive director can only act in an advisory capacity to the board of directors, without voting rights.

Articles or bylaws that call for a minimum of eight board members are also valuable for boards with only eight members in the instance of a board resignation, which leaves the board temporarily with only seven members. As long as the governing documents call for eight and the board can demonstrate it is actively searching for the eighth member, a deduction is still allowed.

The second requirement is that no part of the corporation's income may be paid directly or indirectly to its members, stockholders, officers, directors or trustees, except in the form of services rendered by the corporation in accordance with its purposes and bylaws. This requirement is intended to limit the ability of others to profit indirectly from the operations of the nonprofit. This does not limit the ability of the organization to reasonably compensate officers who are not board members, to pay board stipends, or to provide services to board members who are also constituents served by the nonprofit.

Artistic and cultural organizations are also exempt from paying the retail sales or use tax on certain objects used for the purposes of exhibition or presentation to the general public. These objects include objects of art or cultural value and objects to be used in displaying art or presenting artistic or cultural exhibitions or performances.

d. Exemptions for Other Specified Organizations

- **Blood, Bone, and Tissue Banks.** Blood, bone and tissue banks are exempt from the B&O tax to the extent amounts received are exempt from federal income tax.
- **Adult Family Homes.** Adult family homes are exempt from the B&O tax.
- **The Red Cross.** State law specifically exempts this organization from the B&O tax.
- **Sheltered Workshops.** Sheltered workshops are exempt from the B&O tax. The operation of sheltered workshops means performance of business activities of any kind, on or off the premises of a nonprofit organization, which are performed for the primary purpose of either (1) providing gainful employment or rehabilitation services to the handicapped as an interim step in the rehabilitation process for handicapped individuals who cannot be readily absorbed in the competitive labor market or during such time as employment opportunities for the handicapped in the competitive labor market do not exist; or (2) providing evaluation and work adjustment services for handicapped individuals.
- **Comprehensive Cancer Centers.** Comprehensive cancer centers are exempt from the B&O tax to the extent amounts received are exempt from federal income tax.
- **Organ Procurement Organizations.** Organ procurement organizations are exempt from the B&O tax to the extent amounts received are exempt from federal income tax.
- **The State, the Federal Government, and Housing Authorities.** These organizations are exempt from B&O tax.

e. Exemptions and Deductions for Fundraising Activities

(i) Generally

Washington allows certain nonprofit organizations, as defined below, to deduct income received from a qualifying fundraising activity from the B&O tax. In addition, the nonprofit is not required to collect the retail sales tax on sales made as part of the fundraising activity.

“Fundraising activity” means activities involving both the direct solicitation of money or other property and the anticipated exchange of goods or services for money between the soliciting organization and the organization or person solicited, for the purpose of furthering the goals of the nonprofit organization.

A fundraising activity does not include the operation of a regular place of business in which sales are made during regular hours such as a bookstore, thrift shop, restaurant or similar business. It also does not include the operation of a regular place of business from which services are provided, such as retail, personal, or professional services.

“Nonprofit organization,” for the purpose of the fundraising activity exemption, means one of the following:

- An organization exempt from tax under § 501(c)(3), (4), or (10) of the Code;
- A nonprofit organization that would qualify for the exemption except that it is not organized as a nonprofit corporation; or
- A nonprofit organization that meets all of the following criteria: (1) the members, stockholders, officers, directors or trustees of the organization do not receive any part of the organization’s gross income, except as payment for services rendered; (2) the compensation received by any person for services rendered to the organization does not exceed an amount reasonable under the circumstances; and (3) the activities of the organization do not include a substantial amount of political activity, including, but not limited to, influencing legislation and participation in any campaign on behalf of any candidate for political office.

(a) Retail Sales Tax Exemption for Items Purchased for Fundraising Activities

Organizations that purchase items to be resold as part of a qualifying fundraising activity may either purchase the items to be resold without payment of the retail sales tax if the organization has a reseller’s permit, or pay tax at the point of sale and take the credit for tax paid at source. For example, a qualifying nonprofit has an annual auction at which it serves a meal. If the attendees pay a fee to the nonprofit to come to the event, the nonprofit is reselling the meal to the attendees. Therefore, the nonprofit gives the caterer or hotel a reseller’s permit for the meals and does not pay retail sales tax on the purchase of the meals because of the resale exemption. The nonprofit also does not collect retail sales tax on the fee received from attendees due to the fundraising exemption discussed earlier.

(b) Other State Tax Consequences of Fundraising Activities

Nonprofit organizations must still pay the retail sales tax on consumable items incorporated into fundraising activities. For example, if as part of an auction, an organization rents a hotel ballroom, buys decorations, or pays the caterer or hotel table rental fees, those purchases are consumable items, and the organization must pay sales or use tax on the purchases.

Buyers of tangible personal property will still owe the use tax on all purchases of applicable items at any fundraiser. Thus, while a nonprofit organization has no retail sales tax

collection responsibilities for such items, the buyer must still pay use tax on the items purchased. (See discussion on the use tax in Chapter 52.)

Nonprofit organizations exempt from real or personal property taxes are allowed to use their exempt property for fundraising purposes for limited time periods without impairing their property tax exemptions. The use of exempt property for fundraising activities sponsored by an exempt organization does not subject the property to taxation if the fundraising activities are consistent with the purposes for which the exemption was granted. For property tax exemption purposes, the term “fundraising” means any revenue-raising activity limited to less than five days in length that disburses 51% or more of the profits realized from the activity to the exempt nonprofit organization conducting the fundraising activity.

(c) Trade Shows, Conventions and Seminars

Nonprofit organizations may deduct attendance and space charges received in connection with trade shows, conventions and seminars from the B&O tax if the following conditions are satisfied:

- The sponsoring organization must be exempt under § 501 of the Code;
- The sponsoring organization must either be a “trade organization” or a “professional organization.” A “professional organization” is an entity whose members are engaged in a particular lawful vocation, occupation or field of activity of a specialized nature. A “trade organization” is an entity whose members are engaged “in trade” (i.e., in one or more lawful commercial trades, businesses, crafts, industries or distinct productive enterprises); and
- The event must not be open to the general public. This means that (1) attendance is limited to members of the sponsoring organization and to specific invited guests of the sponsoring organization; or (2) if attendance is not limited to members and specifically invited guests, all proceeds from the trade show, convention or seminar are subject to B&O tax.

(d) Exemptions and Deductions for Specific Revenue Streams

- **Rents.** Rents received from long-term leases of real property for periods of 30 days or more are exempt from the B&O tax. Otherwise, rental income is likely subject to the B&O tax. For example, short-term rentals by those who hold themselves out to the public as hotels and motels are subject to the retailing B&O tax. In addition, the organization must collect the retail sales tax and remit it to the state; short-term rentals of other types of real property are subject to the service and other activities B&O tax; and rentals of personal property are subject to the retailing B&O tax, and the organization must collect and remit the retail sales tax to the state.

- **Advancements and Reimbursements.** Advancements and reimbursements received by nonprofit organizations are excludable if the organization receiving the reimbursement had no liability other than as agent when the original payment was made. Nonprofit organizations should be aware, however, that this possible deduction poses a significant audit trap, especially for affiliates or subsidiaries of the organization and any cost sharing relationships. Reimbursement arrangements must be carefully structured to avoid being treated as taxable gross receipts.
- **Income Exempt Under the U.S. Constitution.** The federal constitution prohibits Washington from taxing revenue derived from interstate sales, imports and exports, Indians and Indian tribes, or sales made by the federal government. Nonprofit organizations that sell to the federal government are generally subject to the B&O tax.
- **Investment Income.** Investment income is deductible. Investment income includes amounts derived from investments, amounts derived as dividends or distributions from a capital account, or amounts derived from interest on loans between a subsidiary entity and its parent, but only if the total investment and loan income of the parent is less than 5% of total annual gross receipts.

This deduction does not apply to amounts received by a banking, lending, or security business. In addition, no deduction is allowed for any organization for loans or the extension of credit to another, revolving credit arrangements, installment sales, and the acceptance of payment over time for goods or services.

- **Bona Fide Dues.** A nonprofit organization may deduct the bona fide dues of its members. Bona fide dues are defined as those amounts paid periodically by members solely for the purpose of entitling those persons to continued membership in the club or similar organization.

A nonprofit organization may not be eligible for this deduction, however, if, in consideration of the dues, the members receive significant goods or services or if dues are graduated based on the level of services provided.

The Department of Revenue has ruled that a nonprofit organization may provide the following significant goods and services without causing the deduction for dues to be lost: (1) the provision of newsletters of a general informational nature to members; (2) the conduct of regulatory and legislative liaison or lobbying activities of a nonspecific nature on the behalf of members; (3) the conduct of conventions and shows for members; (4) the conduct of meetings and seminars of general and varied interest to members; and (5) member discounts for goods and services, which will not cause a portion of dues to be taxable if those members are separately charged for the goods and services and the charges are, after discounts, for at least the full cost of the goods and services.

Although bona fide dues may be deductible from the B&O tax, in some cases dues are apportioned between deductible and nondeductible amounts. For example, physical fitness services of a noninstructional nature are subject to the retailing B&O and retail sales tax. Therefore, if a nonprofit organization provides these services in exchange for dues, an organization must allocate dues between taxable and nontaxable amounts.

A deduction is allowed for all membership fees and fees for camping and recreational services if received by a nonprofit youth organization.

Golf businesses are allowed to use market comparisons to allocate dues to retailing.

- **Bona Fide Contributions and Donations.** Gifts, contributions and donations received by a nonprofit organization are not subject to the B&O tax. If the income received is part sale and part gift, the measure of the B&O tax is the lesser of the selling price or the fair market value of the item sold. The excess of the selling price over the fair market value is a nontaxable donation.
- **Initiation Fees.** Initiation fees are deductible. “Initiation fees” means those amounts paid solely to initially admit a person as a member to a club or organization. These fees are only those one-time amounts paid that genuinely represent the value of membership in a club or similar organization. An initiation fee does not include any amount paid for or attributable to the privilege of receiving any goods or services other than mere nominal membership.
- **Tuition Fees.** Tuition fees are deductible. “Tuition fees” includes library, laboratory, health service and other special fees, and amounts charged for room and board by an educational institution when the property or service for which such charges are made is furnished exclusively to the students or faculty of such institution. “Educational institution” means only those institutions created or generally accredited as such by the state. An “educational institution” offers to its students an educational program of a general academic nature.
- **Daycare.** Charges for the operation of privately operated kindergartens are deductible. The Department of Revenue interprets this deduction to include income received by nursery schools, preschools, day care providers and privately operated kindergartens for the care or education of children who are under eight years of age and not enrolled in or above the first grade. A special B&O tax rate of 0.484% exists for those who provide day care services or care of children eight years or older or at the first grade level or above.
- **Endowment Funds.** Income from endowment funds is deductible.

- **Grants.** Grants received by nonprofit organizations may be deductible from the B&O tax under the bona fide contribution and donation deduction. However, if the grants received are in exchange for significant goods or services, the bona fide contribution and donation deduction does not apply. To qualify a grant for this exemption, the grantee may have to establish the grantor has a “gratuitous intent” in making the grant.

A grant is presumed nontaxable if three conditions are met: (1) the grantor must receive no significant goods, services or benefits in return for making the grant; (2) the grantee is a nonprofit or governmental organization; and (3) the grant must be used to promote, advance or fulfill charitable purposes, including related administrative expenses, within the meaning of § 501(c)(3) of the Code.

A safe harbor provision exists for certain restrictions imposed by the grantor regarding grantee accountability. This provision permits a grantor to place restrictions on the use of the grant for specific charitable purposes and provides that a grantee may submit accountability reports to the grantor regarding the use of the funds or describing the general nature of the project.

Sponsorship or public acknowledgement that the grantor provides a grant alone does not trigger B&O tax liability for the grantee.

Several statutory provisions permit nonprofit research institutions to reduce their potential tax liability. A special B&O tax classification exists for nonprofit organizations that engage in research and development within Washington. The rate is 0.484%. In addition, if a grant is otherwise taxable but services are performed both inside and outside of Washington, a nonprofit can apportion its gross income and pay tax on only the portion attributable to the services performed within the state.

Grants by the federal government to municipal corporations or political subdivisions of the state may be deducted from B&O tax liability.

(e) Health or Social Welfare Organizations

“Health or social welfare organizations” are allowed to deduct grants or fees received from government sources for providing certain “qualifying services.” First, the organization must qualify as a “health or social welfare organization,” which requires that the organization meet the following requirements:

- The organization must be either (A) a nonprofit corporation managed by a governing board of not less than eight individuals, none of whom is a paid employee of the organization or (B) a corporation sole;
- No part of the corporation’s income may be paid directly or indirectly to its members, stockholders, officers, directors or trustees, except in the form of services rendered by the corporation in accordance with its purposes and bylaws;

- Salary or compensation paid to the corporation’s officers and executives must be only for actual services rendered, and at levels comparable to the salary or compensation of like positions within the public service of the state;
- Assets of the corporation must be irrevocably dedicated to the activities for which the exemption is granted and, upon liquidation, dissolution or abandonment by the corporation, may not inure directly or indirectly to the benefit of any member or individual, except a nonprofit organization, association or corporation which would also be entitled to the exemption;
- The corporation must be duly licensed or certified where licensing or certification is required by law or regulation;
- The amounts received qualifying for exemption must be used for the activities for which the exemption is granted;
- Services must be available regardless of race, color, national origin or ancestry; and
- The Department of Revenue must have access to the corporation’s books in order to determine whether the corporation should be exempt.

See the box on page 129 of this Chapter for further discussion of the requirements concerning the board of directors.

Second, “qualifying services” are limited to mental health, drug or alcoholism counseling; family counseling; health care services; therapeutic, diagnostic, rehabilitative or restorative services for the care of the sick, the aged or certain disabled individuals; activities for the prevention of juvenile delinquency or child abuse; care of orphans or foster children; day care of children; employment development, training, and placement; indigent legal services; low-income weatherization or home repairs; low-income heating assistance; or community services to low-income families and groups designed to reduce poverty in a measurable way.

Third, this deduction applies only to amounts the corporation received from the United States or any instrumentality thereof or from the State of Washington or any municipal corporation or political subdivision thereof as compensation for, or to support, health or social welfare services.

Several issues frequently arise surrounding the health or social welfare deduction. If a fee or grant is received from a nongovernmental organization, such as a for-profit organization, a charitable foundation or another nonprofit organization, this deduction does not apply and the nonprofit corporation must analyze its B&O tax liability under the general rule that permits taxation of grants if those grants are exchanged for services. Any compensation for services from a nongovernmental payer is taxable.

The same analysis applies if a qualifying nonprofit corporation receives a government grant to provide services other than services meeting the definition of “qualified services” described above.

Salary or compensation paid to officers and executives must be at levels comparable to the salary or compensation of like positions within the public service of the state. The Department of Revenue has attempted to disqualify an organization from this deduction by showing that the organization’s executives were not paid salaries comparable to salaries paid at like positions in the public service.

(f) Deductions for Public and Nonprofit Hospitals and for Community Health Centers

A public hospital district, a nonprofit hospital, a nonprofit community health center, or a network of nonprofit community health centers that qualifies as a health and social welfare organization is allowed to deduct amounts received as compensation for health care services covered under Medicare, Medicaid, Children’s Health, and the State of Washington Basic Health Plan. The deduction does not apply to amounts received from patient copayments or patient deductibles.

(g) Deductions for Camps and Conference Centers

The B&O tax does not apply to amounts received by a nonprofit organization from the sale or furnishing of certain items at a camp or conference center conducted on property exempt from property tax. Exempt revenues are those for lodging, conference and meeting rooms, camping facilities, parking, and similar licenses to use real property; food and meals; and books, tapes, and other products that are available exclusively to the participants at the camp, conference, or meeting and are not available to the public at large.

(h) Deductions for Childcare Resource and Referral Services

The B&O tax does not apply to nonprofit organizations in respect to amounts derived from the provision of childcare resource and referral services.

(i) Deductions for Credit and Debt Services

The B&O tax does not apply to nonprofit organizations in respect to amounts derived from provision of certain credit and debt services. Exempt services are presenting individual and community credit education programs, including credit and debt counseling; obtaining creditor cooperation allowing a debtor to repay debt in an orderly manner; establishing and administering negotiated repayment programs for debtors; or providing advice or assistance to a debtor with regard to the above-noted services.

(j) Deductions for Group Training Homes

The B&O tax does not apply to income received from the Department of Social and Health Services for the cost of care, maintenance, support, and training of persons with developmental disabilities at nonprofit group training homes. “Group training home” means a

facility equipped, supervised, managed, and operated on a full-time basis for the full-time care, treatment, training, and maintenance of persons with developmental disabilities.

(k) Deductions for Student Loan Programs

B&O tax does not apply to gross income received by nonprofit organizations that are guarantee agencies under the federal guaranteed student loan program, that issue debt to provide or acquire student loans or that provide guarantees for student loans made through programs other than the federal guaranteed student loan program. Qualifying organizations are nonprofit organizations exempt from federal income tax under § 501(c)(3) of the Code.

(l) Deductions for Nonprofit Boarding Homes

The B&O tax does not apply to amounts received by a nonprofit boarding home for providing room and domiciliary care to residents of the boarding home. “Domiciliary care” means assistance with activities of daily living provided by the boarding home either directly or indirectly; health support services, if provided directly or indirectly by the boarding home; or intermittent nursing services, if provided directly or indirectly by the boarding home. “Nonprofit boarding home” means a boarding home that is operated as a religious or charitable organization, is exempt from federal income tax under § 501(c)(3) of the Code, is incorporated under Chapter 24.03 RCW, is operated as part of a nonprofit hospital, or is operated as part of a public hospital district.

Chapter 50. Local Licensing and Local B&O Taxes

State law permits cities to impose a local business and occupation tax. Forty Washington cities assess such a tax, including Seattle, Tacoma, Bellevue, Bellingham, Everett, and Olympia. Each city administers its business and occupation tax independently.

Most cities imposing a local B&O tax follow the state-level definitions of activities such as manufacturing, wholesaling, retailing and services. However, cities offer far fewer exemptions and deductions to their local B&O tax than Washington State does. Moreover, unlike the state-level tax, local B&O taxes are true “gross receipts” taxes and are essentially taxes on the “privilege” of doing business within the city rather than taxes on the actual business activity conducted within the city. Consequently, cities often impose a B&O tax on activities with only minimal connection to business activities conducted within the taxing city.

Most cities with a local B&O tax typically exempt the activity of nonprofits, with the exception of retailing activity, which is subject to tax. The City of Seattle is a notable exception to this rule and subjects more nonprofit activities within its borders to different tax classifications. Because cities have broad freedom to define their local B&O taxes differently from the state and offer different exemptions and deductions, it is advisable to review the local tax code for any city in which an organization has activity.

Even if an organization has otherwise taxable activity, many cities have established an annual minimum gross receipt threshold that must be reached before any tax would be due.

Many Washington cities impose other requirements, such as the need for a business license or other purely local taxes such as the admissions tax, which is a local sales tax on tickets. Nonprofits should contact the finance office of any cities in which they have activities to verify the specific local licensing and tax requirements.

Chapter 51. Retail Sales Tax Issues for Nonprofit Organizations

Washington imposes a tax upon the sale of any article of tangible personal property to consumers and certain services performed for consumers. This is the retail sales tax, which is imposed upon the same activities subject to the retailing B&O tax. Therefore, unless an exemption applies, nonprofit organizations should collect the retail sales tax on all sales of tangible personal property and any services that fall within the definition of retailing.

a. Exemptions

The following sales are exempt from the retail sales tax:

- Sales to the Red Cross;
- Sales of food products for human consumption. The exemption applies only to certain food products that are not sold for immediate consumption on the premises;
- Sales to artistic or cultural organizations of certain objects acquired for exhibition or presentation. This includes objects of art and objects to be used in presenting cultural exhibitions or performances;
- Sales of amusement or recreational services and physical fitness services provided by nonprofit youth organizations;
- Certain fundraising activities;
- Sales of medical supplies, chemicals, or materials to a blood, bone, or tissue bank, comprehensive cancer center, or organ procurement organization;
- Sales of lodging, meals, and books at a nonprofit camp or conference center;
- Sales of drugs for human use pursuant to a prescription;
- Sales of certain medical items such as prosthetic devices, medically prescribed oxygen, osmotic items, and disposable devices used to deliver drugs for human use;
- Sales of meals provided to senior citizens, disabled persons, or low income persons by a nonprofit organization;
- Sales of emergency lodging for the homeless; and

- Purchases of items for resale, including items resold as part of fundraising events.

b. Collection of Sales Tax

The seller acts as the collection agent for the state in collecting the retail sales tax. A seller commits a misdemeanor if it fails to pay collected retail sales taxes to the state by the due date. If a seller fails to collect the required tax on a taxable transaction, the tax remains a debt owed by the buyer to the seller and the seller becomes personally liable for the uncollected tax to the state.

c. Rates

On the Washington State Combined Excise tax return, filers must use four-digit location codes to source local sales or use taxes to the correct jurisdiction. The Department of Revenue quarterly publishes the Local Sales and Use Tax Flyer that contains the codes, rates, and reports of recent changes. The flyer appears online at http://dor.wa.gov/docs/forms/excstx/locsalusetx/localsuseflyer_quarterly.pdf.

Chapter 52. Use Tax Issues for Nonprofit Organizations

Washington imposes a tax on the user of any article of tangible personal property or certain services acquired by purchase or gift where the user or donor has not paid the retail sales tax.

a. Rates and Reporting

The use tax rates are the same as the combined state and local portions of the retail sales tax.

Nonprofits are required to accrue and remit their use tax obligations on the Combined Excise Tax Return, the same form used to pay the B&O tax and remit collected sales tax. Smaller organizations that are not required to be registered with the Department of Revenue can remit their use tax obligations on the Consumer Use Tax Return, which is available from the Department of Revenue.

b. Liability When No Sales Tax Is Collected

Most nonprofit organizations, like most other consumers and businesses, have contingent use tax liabilities for small items purchased such as:

- Computer equipment, computer parts, software licenses, and software purchased from out-of-state sources;
- Purchases from small in-state unregistered service providers such as contractors, landscapers, and information technology service providers;
- Any mail order catalog items;

- Items purchased over the Internet;
- Fixed assets shipped into Washington from a seller outside of Washington who does not collect the retail sales tax;
- Magazine and periodical subscriptions; and
- Office supplies, if purchased from out-of-state sources.

c. Donations of Property

The use tax does not apply to use by a nonprofit charitable organization or state or local governmental entity of any item of tangible personal property that has been donated to the nonprofit charitable organization or state or local governmental entity.

The use tax does not apply to the donation of tangible personal property without intervening use to a nonprofit charitable organization, or to the incorporation of tangible personal property without intervening use into real or personal property of or for a nonprofit charitable organization in the course of installing, repairing, cleaning, altering, imprinting, improving, constructing, or decorating the real or personal property for no charge.

d. Donations of Retailing Services

The use tax does not apply to the use by a nonprofit charitable organization of labor and services rendered in respect to installing, repairing, cleaning, altering, imprinting, or improving personal property provided to the charitable organization at no charge, or to the donation of such services.

The use tax does not apply to the donation of amusement and recreation services without intervening use to a nonprofit organization or state or local governmental entity, to the use by a nonprofit organization or state or local governmental entity of amusement and recreation services, or to the subsequent use of the services by a person to whom the services are donated or bailed in furtherance of the purpose for which the services were originally donated.

e. Real Estate Excise Tax Issues

Washington imposes a transfer tax on the sale of real property including leasehold improvements and those involving a 50% or more controlling interest in any entity that owns the real property.

Nonprofit organizations, even if exempt from real or personal property taxes, are nevertheless subject to the real estate excise tax unless the transaction is otherwise specifically exempt.

There are numerous exceptions to the real estate excise tax, including:

- Gifts of real property;

- Transfers of real property that consist of a mere change in the identity or form of ownership; and
- Transfers of real property that for federal income tax purposes do not involve the recognition of gain or loss for the purposes of entity formation, dissolution or reorganization.

Chapter 53. Property Tax Issues

Washington exempts qualifying nonprofit organizations from the payment of:

- Real property taxes;
- Personal property taxes; and
- Leasehold excise taxes. The leasehold excise tax is a 12.84% tax on leasehold interests in publicly owned real or personal property. The tax base is measured by the amount paid for the use of the property. If a nonprofit organization receives the use of donated property, the tax base is the fair market value of the rents on similar property.

a. Exemptions Limited to Certain Nonprofit Activities

Not all nonprofit organizations qualify for exemption from payment of property taxes. Exemptions are only allowed for specific types of activities. Qualifying activities include:

- Public property;
- Cemeteries, churches, parsonages, convents, and grounds;
- Property used for character building, benevolent, protective or rehabilitative social services, camp facilities, veteran or relief organization-owned property, and property of nonprofit organizations that issue debt for student loans or that are guarantee agencies;
- Administrative offices of nonprofit religious organizations;
- Nonprofit organizations engaged in procuring, processing, etc., blood, plasma or blood products;
- Nonprofit organizations' property connected with operation of public assembly halls or meeting places;
- Nonprofit day care centers, libraries, orphanages, homes or hospitals for the sick or infirm, and outpatient dialysis facilities;
- Nonprofit homes for the aging;

- Nonprofit organizations' property used in providing emergency or transitional housing to low-income homeless persons or victims of domestic violence;
- Nonprofit organizations' property available without charge for medical research or training of medical personnel;
- Nonprofit cancer clinics or centers;
- Nonprofit organizations' property used for transmission or reception of radio or television signals originally broadcast by governmental agencies;
- Schools and colleges;
- Art, scientific and historical collections and property used to maintain such collections; property of associations engaged in the production and performance of musical, dance, artistic, etc., works; property to be used for an exempt purpose in the future; fire engines, implements, and buildings of cities, towns, or fire companies; and property owned by humane societies;
- Water distribution property owned by nonprofit corporations or cooperative associations; and
- Property owned or used for sheltered workshops for handicapped.

b. Application for Exemption

A nonprofit organization must apply in advance of receiving an exemption for property taxes and renew its exemption with the Department of Revenue by March 31 of each year.

c. Uses of Exempt Property

Once exempt, the property must be exclusively used for its exempt purpose. As a general rule, the loan or rental of all or a portion of the exempt property does not subject the property to property taxes if:

- The rents or donations received for the use of the property are reasonable and do not exceed the maintenance and operation expenses attributable to the portion of the property loaned or rented; and
- The property would be exempt from tax if owned by the organization to which it is loaned or rented.

If exempt property is loaned or rented, the tax-exempt status of the property will not be affected if:

- The property is loaned or rented for a period of 15 consecutive days or less;

- The property is loaned or rented to another nonprofit organization, association, or corporation that would qualify for exemption if it owned the loaned or rented property; and
- All income received from the rental is devoted exclusively to the exempt purpose of the nonprofit organization that receives the tax exemption.

If the property is loaned or rented and the lessor or lessee intends to produce revenue from the loan or rental, the property loses its exemption. Property loaned or rented from which revenue is to be produced must be segregated and taxed whether or not the revenue is devoted to exempt purposes. Over the last few years, exceptions have been created for a limited number of organizations that allow small daily amounts of commercial use. For example, veteran organizations' property and public assembly halls are allowed 15 days per year of commercial use. Nonprofit performing arts groups, nonprofit museums, and nonprofit schools are allowed seven days per year of commercial use. (Rental income may be subject to Business and Occupations Tax as discussed in Chapter 49.)

The use of exempt property for "fundraising" activities sponsored by an exempt nonprofit organization does not subject the property to taxation if the fundraising activities are consistent with the purposes for which the exemption was granted. "Fundraising" means any revenue-raising activity limited to less than five days in length that disburses 51% or more of the profits realized from the activity to the exempt nonprofit organization conducting the fundraising.

Chapter 54. Further Information

More information on Washington taxes may be obtained by contacting the Department of Revenue, as follows:

State of Washington
Department of Revenue
Taxpayer Information and Education
Telephone 1-800-647-7706

The Department of Revenue also maintains an Internet site with access to laws, rules, forms, and the Department's topical publications and notices. The address is <http://dor.wa.gov/content/home/>.

More information on local business and occupation taxes and licensing issues may be obtained by contacting the finance office of the city in question.

The following resources may searched online at the listed sites:

- **Revised Code of Washington.** The best and most readily searchable Revised Code of Washington is available through the website for the Municipal Research Service Center. This is a foundation that is sponsored by the Association of Washington Cities. The address is <http://www.mrsc.org>.

- **Taxpedia.** Taxpedia is the free state tax research service from the Department of Revenue. It provides access to laws, rules, advisory bulletins, precedents from the Department's Appeals Division, the Board of Tax Appeals, and the courts. It is located at <http://taxpedia.dor.wa.gov/index.html>.

PART IX. FISCAL SPONSORSHIPS, JOINT VENTURES AND OTHER COLLABORATIONS

Chapter 55. Working With Others

It is often advantageous, for financial or programmatic reasons, to work with other organizations to further your own organization's objectives. In doing so, you must take care not to jeopardize your organization's tax-exempt status by ceding too much control to others or by unwittingly furthering noncharitable purposes. The following chapters outline two common ways in which organizations work with others: through fiscal sponsorships and contractual collaboration (or joint ventures). For a discussion of nonprofit mergers and consolidations, see Chapter 71.

Chapter 56. Fiscal Sponsorships

Many public and private donors will give money only to tax-exempt organizations so that they can take a charitable deduction for their donations on their federal income taxes. Frequently, organizers of projects that have not been qualified as tax-exempt (and may never be) and thus cannot offer donors the advantage of a tax deduction can establish a "fiscal sponsorship" with a tax-exempt entity in order to attract donations for a particular project that may be tax-advantaged to the donor. Historically, the term "fiscal agency" was used to describe this type of relationship. The term is now disfavored by the IRS and should not be used. For a discussion on whether to seek fiscal sponsorship for your organization, see Chapter 2.

In a fiscal sponsorship, the tax-exempt entity (the sponsoring organization) agrees to receive and disburse funds for the project on behalf of the non-tax-exempt entity (the sponsored organization). Checks are made out directly to the sponsoring organization, which runs the funds through its books and includes the funds as part of its income on its reports to the IRS, and disbursements are then made to or on behalf of the sponsored organization. An administrative fee is usually paid to the sponsoring organization.

In Revenue Ruling 68-489, 1969-2 C.B. 210, the IRS set forth the following guidelines for a fiscal sponsorship to ensure that such arrangements are not used to circumvent laws governing charitable giving: (1) the sponsored project must further the sponsoring organization's own charitable purpose; (2) the sponsoring organization must maintain records establishing that the funds were actually used for such purposes; and (3) the sponsoring organization must retain "complete control and discretion" over the use of the funds. In other words, the sponsoring organization becomes legally and financially responsible for the project it agrees to sponsor.

With respect to the first guideline, the sponsoring organization should determine not only that the project will further a specific charitable purpose of the sponsoring organization but also that the sponsored project will not engage in any other activities that might jeopardize the sponsoring organization's tax-exempt status. For example, political activities should be prohibited and lobbying restricted during the term of the fiscal sponsorship. With respect to the second guideline, the sponsoring organization should establish procedures for

ongoing oversight, for example by requiring periodic reports regarding the use of any funds disbursed for the sponsored project.

The third guideline reflects that the sponsoring organization cannot be a mere conduit through which otherwise nondeductible donations are made to the sponsored organization. If a check is made to the sponsoring organization with a requirement that it be disbursed for the sponsored project, the IRS deems that a donation has been made to the nonexempt sponsored project and no deduction is allowed. To avoid this “pass through” characterization, the sponsoring organization must have discretion to refuse to disburse funds if the sponsored project engages in any prohibited activities or uses the funds for purposes other than the agreed-to project.

All parties should realize that in a fiscal sponsorship there are actually two levels of granting. In the first level, the donor agrees to make a grant to the sponsoring organization, usually provided certain conditions are satisfied. In the second level, the sponsoring organization agrees to support the sponsored project, again provided certain conditions are satisfied. Thus, the sponsoring organization is responsible for satisfying any requirements of the original donor, and the sponsored project is responsible for satisfying the requirements of the sponsoring organization.

There should therefore be two agreements, one between the original donor and the sponsoring organization, the other between the sponsoring organization and the organizers of the sponsored project. The agreement between the original donor and the sponsoring organization should, among other things, provide that the sponsoring organization has “complete discretion and control” over the funds. Where there is no written agreement, the sponsoring organization should send an acknowledgment or receipt stating that the funds will be used on behalf of the project (less an administrative fee) so long as the project continues to further the sponsoring organization’s own charitable purposes.

The agreement between the sponsoring organization and the organizers of the sponsored project should be in writing and should set forth:

- A description of the project and the charitable purpose it furthers;
- Any performance requirements for the project;
- Prohibited and restricted activities of the project;
- When and how donations will be solicited and whether there will be any restrictions on solicitations (to avoid situations where multiple requests are made to the same source);
- When and how donations will be remitted to the sponsoring organization and disbursed to the sponsored project;
- Responsibility for providing acknowledgments and receipts to donors;

- The extent to which the sponsoring organization and the project will be identified in promotional materials;
- Clarification of employment and/or supervisory relationships for any personnel involved in the project;
- Timing and nature of financial reports from the sponsoring organization to the sponsored project;
- Timing and nature of project reports from the sponsored project to the sponsoring organization;
- The amount of any administrative or other fees charged by the sponsoring organization (either as a fixed fee or a percentage of funds received);
- The duration of the fiscal sponsorship;
- Indemnification and insurance provisions; and
- Events of and remedies for default (including specifically the ability of the sponsoring organization to cease making disbursements or demand return of funds if the grant conditions are not satisfied).

Chapter 57. Joint Ventures and Other Collaborations

Sometimes a donor may not want to just make a grant of funds to an organization but wants to also collaborate with the organization in furthering its charitable purpose. There may be an instance where an organization with a mission compatible to yours desires to collaborate with you to further a charitable purpose. There are two basic models of collaboration (sometimes called joint ventures): project-specific, where the two organizations partner to fulfill a specific project or goal; and comprehensive, where organizations partner to fulfill a comprehensive set of shared goals. In either of these cases, there may be risks to your organization's tax exemption. In particular, where a collaboration is with a for-profit entity, you should guard against private inurement, unrelated business income, and illegal shelters of taxable income. For more information, see Chapters 25-34.

Regardless of the model being proposed, the two organizations should, as in any partnership, enter into a written agreement that sets forth their respective rights and obligations. There are as many different models of partnership agreements as there are attorneys able to draft them. Some of the more important details to consider in forming any type of partnership, which should eventually be included in a written agreement between the two organizations, include (in no specific order):

a. Vision/Goals

It is important that the partners share the same vision, expectations and goals with respect to their participation in the partnership. These need to be clearly defined from the outset. Why does each of the partners want to participate in this partnership? Does the partner

organization have a primary interest in furthering your organization's purposes? Does it have other interests, such as attracting positive public recognition or assisting your organization in its overall capacity-building efforts? Does the partner organization have any goals that conflict with those of your organization? Can your organization pursue other goals without the partner organization? Will your or the partner organization object to having its name associated with the other organization in areas in which the two organizations are not collaborating?

b. Control and Decision Making

After a shared vision and goals, the issue of control is probably the most important factor to consider. If you are, or aspire to be, a tax-exempt entity, all of your decisions must be made in furtherance of your charitable purposes. If you yield too much decision-making control to another organization, even another nonprofit, you run the risk that some decisions will not further your own (charitable) purposes and this, in turn, can jeopardize your tax-exempt status. Thus, you need to consider carefully which organization gets to make decisions over which issues, including, for example, program design and implementation and funding priorities. You also need to consider how decisions are made. You could, for example, dedicate a governing or advisory board seat of one or both organizations to a representative from the other organization(s). Or you could agree that certain decisions will require the approval of both organizations. Or you could agree to establish an entirely new entity in which both organizations are equal partners. In any event, there need to be well-defined decision-making processes and transparency, as well as a defined process for resolving inevitable disagreements. The agreement should also state whether and how any additional parties may join as partners.

c. Funding

If the partner organization is providing funding, the agreement needs to state clearly what this funding will cover. A project budget that specifies the sources and uses of all funds should be attached as an exhibit to the agreement, and the agreement should state whether and how the budget may be modified. The agreement should specify the extent to which donated funds are discretionary or restricted. It should also specify the extent to which additional fundraising is required, how any additional funding will be disbursed as between the two organizations (or the new one), whether any costs are to be covered by others, and whether there are in-kind contributions or previously dedicated funds that need to be calculated when determining the respective contributions of the partners. If you are contracting with a donor, the agreement should state the purposes for which funds may be used, the circumstances or conditions under which funds will be disbursed (such as whether certain milestones must be accomplished) and whether there are any circumstances under which funds would have to be returned (for example, for breach of the agreement). Will your organization's books and records be subject to review and/or audit by the funding organization?

d. Implementation

Issues to resolve in connection with implementation include identification of each partner's respective roles and responsibilities for implementation of the project. What are the

strengths and expertise of each partner in areas such as fundraising, political savvy, project implementation, public relations, and staff support, etc.? To what extent will each partner be involved in day-to-day operations? Will some responsibilities be shared and others carried out by only one of the organizations? What is the time frame for implementation? Can any responsibilities be assigned or subcontracted?

e. Communication

Who speaks for each organization and in what ways? How do the two organizations communicate between themselves? How do they communicate with third parties and the public?

f. Accountability

What standards will you utilize to show each other that you are performing your respective responsibilities? How will you measure progress towards your collective goals? What specific targets or benchmarks are important to acknowledge? What reporting and monitoring standards and procedures will you utilize, for example, in areas of accounting, project implementation, audit and evaluation? How frequent will these reports be?

g. Intellectual Property Rights

Who will own any materials created during the course of the collaboration? Can those materials be used by third parties? What will become of those materials upon termination of the partnership? Will the collaboration result in the use or creation of any trade names or marks? Who is entitled to use those during and upon the termination of the partnership?

h. Taxes, Indemnification and Insurance

Which of the two organizations will be responsible for receiving funds and reporting the funds as income? Will either organization be responsible for employment taxes? Will any insurance requirements be imposed on either organization (liability, medical, travel, life, etc.)? Will either organization be required to add the other organization as an additional insured? Will one party indemnify the other?

i. Duration

How long will the partnership last? Under what circumstances can the partnership be terminated before the agreed-upon termination date (for example, loss of funding or breach of the agreement)? What are the consequences? Will either organization owe money to the other? Will the parties agree in advance to an alternative dispute resolution process, such as mediation or arbitration, over litigation?

j. Recognition/Visibility

What type of recognition will each organization expect from its participation in the partnership? Will you acknowledge each other in written materials or on your respective websites? Will you send out press releases? What other type of public recognition will be required?

k. Personnel

Who will do the work of the partnership? Will it be employees of one of the partners? How will they be paid and who will supervise them?

As should be apparent from the foregoing list, there are many issues to be resolved in forming a partnership. Although the foregoing list is a good point of departure for discussing a potential collaboration, you would be well-served to consult with an attorney and/or accountant before embarking on any such enterprise to ensure that your legal and financial interests are protected in a written agreement.

Your advisors will also be able to tell you whether it makes sense to create a separate entity (usually a subsidiary of your organization) to enter into the agreement with your partner. The rules governing subsidiary organizations are complex, and a number of different types of subsidiary organizations can be created (for example, a corporation, partnership or limited liability company) depending on the specific circumstances of your organization and what it is hoping to accomplish. Briefly, however, if properly formed and maintained, a subsidiary can be used to shield your organization from potential tax liability and from jeopardizing its tax-exempt status were the partnership to engage in activities that do not further your organization's charitable purpose, and it can also protect your organization from contractual and other types of liability by shielding your organization's assets.

PART X. EMPLOYMENT ISSUES

Chapter 58. Application of Employment Law to Nonprofits

An increasingly complex labyrinth of statutory and common law governs the employer-employee relationship. Nonprofit organizations as a general rule are not exempt from these laws. The array of employment law compliance issues facing nonprofit employers is far too extensive and complex to cover in detail in these materials. This part, however, highlights areas of employment law with which every nonprofit employer should be familiar. For specific advice, you should consult an attorney.

Chapter 59. Classification of Workers

a. “Volunteer” Versus “Employee”

Because nonprofit organizations often rely on volunteers to perform responsibilities that might be performed by employees in a for-profit organization, it is extremely important that the nonprofit employer understand how “volunteers” differ from “employees” under the law. Generally speaking, a person is considered a volunteer if he or she performs services for an organization without any expectation of, or receipt of, compensation for his or her services.

The Washington Minimum Wage Act (“WMWA”), Chapter 49.43 RCW, expressly exempts from its coverage volunteer work for nonprofit organizations. RCW 49.46.010(5) (emphasis added) provides as follows:

“Employee” includes any individual employed by an employer
but shall not include:

....

(d) Any individual engaged in the activities of an educational, charitable, religious, state or local governmental body or agency, or nonprofit organization where the employer-employee relationship does not in fact exist or where the services are rendered to such organizations gratuitously.

The Washington Department of Labor and Industries (“L&I”) has issued an Administrative Policy Statement indicating that the department uses the following interpretation in determining whether workers are truly volunteers exempt from the WMWA:

- “Individuals will be considered volunteers only where their services are offered freely and without pressure or coercion, direct or implied, from an employer.”
- “Individuals who volunteer or donate their services, usually on a part-time basis, for public service or for humanitarian objectives, not as employees and

without contemplation of pay, are not considered employees of the entities that received their services.”

- “[I]f [volunteers] are paid for their services beyond reimbursement for expenses, reasonable benefits or a nominal fee, they are employees and not volunteers. Individuals do not lose their volunteer status if they receive a nominal fee or stipend.”
- “An individual will not be considered a volunteer if he or she is otherwise employed by the same agency or organization to perform similar or identical services as those for which the individual proposes to volunteer.”

Minimum Wage Act Applicability, Admin. Policy No. ES.A.1, at 3 (rev. ed. 2006) (*see* <http://www.lni.wa.gov/workplacerrights/files/policies/esa1.pdf>).

Under the WMWA, any individual providing services as a volunteer who then receives wages for services is no longer exempt and must be paid at least minimum wage and overtime pay for hours worked in excess of 40 hours per workweek. Unpaid employment is unlawful. An employee-employer relationship is deemed to exist.

An employer should make sure that any “volunteering” is truly voluntary, and, if the individual is an employee, avoid any implication that volunteering is a requirement of the job. An employer who has employees volunteering should make sure that:

- The services are entirely voluntary (without contemplation of pay), there is no coercion to volunteer, and no penalty for not volunteering;
- The activities are predominately for the employee’s benefit;
- The employee does not replace another employee while volunteering;
- The activity does not take place during the employee’s regular working hours; and
- The volunteer time is insubstantial in relation to the employee’s regular hours.

Whether using employee volunteers or regular volunteers, employers should strongly consider drafting a short form that a volunteer signs before he or she begins volunteering. The employee volunteer form should incorporate points 1, 2, and 4 above, and the nonemployee volunteer form should include point 1 above.

See also Chapter 67 for a discussion of the issue of who owns intellectual property created by volunteers.

b. “Independent Contractor” versus “Employee”

A person who performs services for an organization with an expectation or understanding that he or she will be paid for his or her services is either an independent

contractor or an employee. The tests for determining an individual's status vary according to the applicable law. Under the federal law governing minimum wages and overtime, the Fair Labor Standards Act ("FLSA"), courts use an "economic reality" test to determine whether the worker is an employee. For most other purposes, such as income tax withholding, courts apply the "right of control" test described below. While there are some persons who could be deemed employees for purposes of the FLSA but not for other purposes, such cases are rare.

(i) Independent Contractor

A person who performs work for an organization with the expectation of being paid for such work will be considered an independent contractor if he or she does not meet any of the following tests for being an employee.

(ii) Common Law Employee

The test for determining whether a worker is an employee for purposes of income tax withholding, social security tax contributions and ERISA coverage is whether the employer has "the right to control the manner and means by which the work is accomplished."

An individual will be considered an employee when the person for whom he or she performs services has the right to control and direct the services, the result to be accomplished and the details and means by which that result is accomplished. It is not necessary that the employer actually direct or control the manner in which the services are performed; it is sufficient if the employer has the right to do so. If an individual is subject to the control or direction of another merely as to the result to be accomplished and not as to the means and methods for accomplishing the result, he or she is an independent contractor.

A court will consider the following factors in determining whether the "right of control" test is met:

- **The Skill Required to Perform the Work.** Workers performing highly skilled work are more likely to be considered independent contractors than workers performing comparatively low-skilled work.
- **Who Provides the Tools and Materials to Accomplish the Work.** If the hiring party provides the tools and materials, this favors a conclusion that the worker is an "employee." If the worker provides his own tools and materials, this favors a conclusion THAT the worker is an "independent contractor."
- **Whether the Work Is Performed at the Employer's Business.** If a worker must perform the work at the hiring party's place of business, this favors a conclusion that the worker is an employee.
- **The Duration of the Relationship Between the Parties.** The longer the duration of the parties' relationship, the more likely it is that the worker will be considered an employee.

- **Whether the Worker Has the Right to Hire and Pay Assistants.** If the worker cannot hire assistants to help, this sometimes supports a conclusion that the worker is an employee.
- **Whether the Hiring Party Has the Right to Assign Additional Work to the Worker.** If the hiring party has the right (whether hiring party does so or not) to assign extra work to the worker, this supports a conclusion that the worker is an employee.
- **Method of Payment.** Payment by payroll check, payment on a salary basis, or payment for hourly work would tend to support a conclusion that the worker is an employee.
- **Whether the Work Is Part of the Regular Business of the Hiring Party.** If the nature of the work performed is part of the regular business of the hiring party, the worker performing such work is more likely to be considered an employee.
- **The Extent of the Worker’s Discretion Over When and How Long to Work.** The less discretion the worker has over when to work and for how long, the more likely it is that the worker will be considered an employee.
- **Whether the Hiring Party Is in Business.** A worker hired as an independent contractor who does not have any indicia of being in business (does not have a business license, tax ID number, etc.) is more likely to be considered an employee.
- **Whether the Worker Receives Employee Benefits.** If a worker receives benefits usually given to employees, the worker is more likely to be considered an employee.
- **How the Parties Treat the Worker for Tax Purposes.** How the parties themselves characterize their relationship is relevant, but not a controlling factor. If the facts otherwise indicate that the worker is an employee, an agreement between the parties to the contrary is not sufficient to alter the employee’s status.

The “right of control” test requires all of these factors to be considered and weighed. No one factor is decisive and there is no shorthand formula or magic phrase that can be applied to find the answer. After considering all of these factors, if a person is not found to be an employee, he or she will be considered to be an independent contractor.

Chapter 60. Antidiscrimination Laws

a. The Prohibitions

Under federal, state, and local law, a nonprofit employer may not refuse to hire an applicant, or treat an employee less favorably in the terms and conditions of employment, or

fire an employee because of the race, color, religion, sex, disabling condition, age or national origin race of the applicant or employee. The Washington Law Against Discrimination (the “WLAD”) also prohibits discrimination on the basis of marital status and sexual orientation. The Seattle Municipal Code also prohibits discrimination in hiring on the basis of sexual orientation, gender identity, marital status and political ideology, as well as on the basis of race, gender, national origin, religion, and disabling condition.

While Title VII of the Civil Rights Act of 1964 (“Title VII”) allows employers to consider the gender, national origin, or religion of an applicant under very limited circumstances involving bona fide occupational qualifications (“BFOQs”), the BFOQ standard is very high, and requires that all or substantially all persons in the excluded class would be unable to efficiently perform the duties and the essence of the operation would be undermined by hiring anyone in that excluded class. A nonprofit employer should consult an attorney before failing to hire an individual on the basis of a BFOQ.

b. Is the Organization a “Covered” Employer?

Whether any or all of these law will govern a particular nonprofit organization will depend on the size of the organization. Title VII applies to all employers engaged in an industry affecting commerce who have 15 or more employees. The term “affecting commerce” has been construed broadly, and many nonprofit organizations have found themselves on the wrong side of a Title VII lawsuit.

The federal Age Discrimination in Employment Act governs employers of 20 or more employees. The federal Americans with Disabilities Act (the “ADA”) governs employers of 15 or more employees. The WLAD applies to the employment practices of employers of eight or more employees. And the Seattle Municipal Code protects the employees of employers with four or more employees from discriminatory employment practices. As a general rule, volunteers do not count toward any of these totals.

c. Assessing Job Qualifications

For practical business reasons, it is in an employer’s best interests to hire the most qualified applicant for a position, regardless of the applicant’s race, gender, national origin, age, sexual orientation, etc. Consequently, the applicant bears the burden of proving that his or her race, gender, national origin, age, sexual orientation, etc., motivated the employer’s decision not to hire him or her.

A comparative analysis of job applicants’ qualifications may, nonetheless, be relevant in proving that an employer’s proffered reasons for not hiring an applicant are a pretext for unlawful discrimination where the employer claims that it based the hiring decision on applicant qualifications. When a nonprofit employer establishes a set of job qualifications, and then for whatever reasons decides to hire an applicant who does not meet the qualifications, the employer’s legitimate nondiscriminatory reason for failing to hire an applicant who is a member of a protected category may be rendered worthless.

d. Disability Discrimination

(i) Hiring Issues

Under the ADA, it is illegal to ask whether the applicant has any disabilities that would prevent him or her from performing the job. An employer may describe particular skills required on the job, and ask whether the applicant can perform those tasks with or without reasonable accommodation. An employer may also ask an applicant to demonstrate how he or she will perform job tasks.

Warning: An employer may not ask an applicant whether he or she needs reasonable accommodation to perform the task. That question requires the applicant to disclose his or her disability and the need for reasonable accommodation.

Generally an employer may not ask about the kinds of accommodation that may be required until after the applicant is hired. (Exception: When an employer could reasonably believe that an applicant will need reasonable accommodation to perform the functions of the job, the employer may ask that applicant certain limited questions. Specifically, the employer may ask whether he or she needs reasonable accommodation and what type of reasonable accommodation would be needed to perform the functions of the job. The employer could ask these questions if: (1) the employer reasonably believes the applicant will need reasonable accommodation because of an obvious disability; (2) the employer reasonably believes the applicant will need reasonable accommodation because of a hidden disability that the applicant has voluntarily disclosed to the employer; or (3) an applicant has voluntarily disclosed to the employer that he or she needs reasonable accommodation to perform the job. Example: An individual with diabetes applying for a receptionist position voluntarily discloses that she will need periodic breaks to take medication. The employer may ask the applicant questions about the reasonable accommodation such as how often she will need breaks, and how long the breaks must be. Of course, the employer may not ask any questions about the underlying physical condition. *See* EEOC Enforcement Guidance on Preemployment Disability-Related Questions and Medical Examinations under the Americans with Disabilities Act [<http://www.eeoc.gov/policy/docs/preemp.html>].) An employer may make a contingent offer of employment and then discuss reasonable accommodation and whether it would cause undue hardship to the business.

(ii) Failure to Accommodate: Disabling Conditions

Both the ADA and the WLAD require employers to reasonably accommodate disabled employees. According to the Equal Employment Opportunity Commission (the “EEOC”) ADA guidelines, in general an accommodation is any change in the work environment or in the way things are customarily done that enables an individual with a disability to enjoy equal employment opportunities. The guidelines provide that there are three categories of reasonable accommodation:

- Accommodations that are required to ensure equal opportunity in the application process;

- Accommodations that enable the employer’s employees with disabilities to perform the essential functions of the positions held or desired; and
- Accommodations that enable the employer’s employees with disabilities to enjoy benefits and privileges of employment equal to those enjoyed by employees without disabilities.

The guidelines also provide a nonexhaustive list of common types of accommodation:

- Making existing facilities used by employees readily accessible to and usable by individuals with disabilities; and
- Job-restructuring; part-time or modified work schedules; reassignment to a vacant position; acquisitions or modifications of equipment or devices; appropriate adjustments or modifications of examinations, training materials, or policies; the provision of qualified readers or interpreters; and other similar accommodations for individuals with disabilities.

(iii) Undue Hardship

The concept of “undue hardship” within the context of a disability discrimination claim differs greatly from the concept of “undue hardship” within the context of a claim of religious discrimination. The threshold for the demonstration of undue hardship is significantly higher in a case involving a claim of disability discrimination than in a claim of discrimination because of religion. According to the ADA and the EEOC regulations amplifying the ADA:

A determination of undue hardship should be based on several factors, including:

- The nature and cost of the accommodation needed;
- The overall financial resources of the facility making the reasonable accommodation; the number of persons employed at the facility; the effect on expenses and resources of the facility;
- The overall financial resources, size, number of employees, and type and location of facilities of the employer (if the facility involved in the reasonable accommodation is part of a larger entity);
- The type of operation of the employer, including the structure and functions of the workforce, the geographic separateness, and the administrative or fiscal relationship of the facility involved in making the accommodation to the employer;
- The impact of the accommodation on the operation of the facility.

See 42 U.S.C. § 12111(10)(B) (1994); 29 C.F.R. § 1630.2(p)(2) (1997); 29 C.F.R. pt. 1630 app. § 1630.2(p) (1997). These factors are important in the nonprofit arena because of the often-limited resources of nonprofit employers.

Common mistakes in the accommodation process include:

- Not asking the employee for medical confirmation of the disability.
- Poorly drafted job descriptions.
- Failure to analyze jobs.
- Snap judgments.
- Not asking the applicant or the employee for suggestions on reasonable accommodation—the reasonable accommodation process is an interactive process.
- Failure to include a human resources staff person in the process.

e. WLAD “Disability” Definition

Nonprofit employers should note that the definition of “disability” is broader under the WLAD than it is under the ADA. In 2007, the Washington State Legislature amended the WLAD to define “disability” as “a sensory, mental, or physical impairment” that is “medically cognizable or diagnosable,” “exists as a record or history,” or is “perceived to exist, whether or not it exists in fact”; and “impairment” includes:

- (i) Any physiological disorder, or condition, cosmetic disfigurement, or anatomical loss affecting one or more of the following body systems: Neurological, musculoskeletal, special sense organs, respiratory, including speech organs, cardiovascular, reproductive, digestive, genitor-urinary, hemic and lymphatic, skin, and endocrine; or
- (ii) Any mental, developmental, traumatic, or psychological disorder, including but not limited to cognitive limitation, organic brain syndrome, emotional or mental illness, and specific learning disabilities.

RCW 49.60.040(25).

The legislation recognizes a disability in a broad range of circumstances, including temporary impairments, regardless of the potential for mitigation, even if the impairment only limits the employee’s ability to do a specific job. Under the law a disability exists whether it is temporary or permanent, common or uncommon, mitigated or unmitigated, or

whether or not it limits the ability to work generally or work at a particular job or whether or not it limits any other activity within the scope of this chapter.

f. Sexual Orientation Discrimination

In 2006 the Washington State Legislature amended the WLAD to prohibit sexual orientation discrimination. The statute defines “sexual orientation” broadly to include “heterosexuality, homosexuality, bisexuality, and gender expression or identity.” The phrase “gender expression or identity” means “having or being perceived as having a gender identity, self-image, appearance, behavior, or expression, whether or not that gender identity, self-image, appearance, behavior, or expression is different from that traditionally associated with the sex assigned to that person at birth.”

g. Harassment

As early as 1980, the EEOC issued guidelines specifying sexual harassment as a form of sexual discrimination prohibited by Title VII. In 1985, the Washington State Supreme Court recognized for the first time that failure to correct a hostile work environment caused by sexual harassment constituted discrimination in violation of the WLAD. The following year the U.S. Supreme Court addressed a claim of sexual harassment brought pursuant to Title VII for the first time. The Court unanimously held that a claim of sexual harassment is actionable under Title VII where a hostile environment is created by such harassment, even though the harassment has no tangible economic impact on plaintiff’s employment.

Today’s workplace harassment claims reach far beyond gender-based claims. The Washington Supreme Court has confirmed that the WLAD provides employees with a cause of action for disability-based hostile work environment harassment. Federal courts have upheld hostile work environment harassment claims against employers based on same sex sexual harassment and harassment based on religion, race and national origin, and claims arising out of harassment based on sexual orientation. Nevertheless sexual harassment claims continue to make up a significant percentage of the number of employment-related lawsuits filed against employers each year.

A prudent employer should have in place:

- A clear antiharassment policy informing all employees that workplace harassment based on sex, race, or any other protected classification will not be tolerated and will result in disciplinary action. The policy should also contain a clear complaint procedure, including an option enabling the complaining employee to bypass the alleged harasser as well as assurances that employees who do make claims of harassment will be protected from retaliation;
- Documented distribution of the employer’s antiharassment policy. Many employers require employees to individually sign a statement to confirm receipt; and
- Training programs to ensure that managers and employees understand what constitutes sexual harassment, and how the employer’s sexual harassment complaint procedure operates.

h. Terminations in Violation of Antidiscrimination Statutes

Claims of termination in violation of antidiscrimination statutes generally take the form of claims of disparate treatment because of some protected characteristic or status (i.e., “you fired me because I’m a woman”). The essence of the disparate treatment claim is the statutory prohibition against treating an employee **less favorably** because of that individual’s race, sex, national origin, religion, age, marital status, sexual orientation or disabling condition.

Although the burden of proof lies with the former employee who claims that he or she was fired because of his or her race, gender, disabling condition, etc., as a practical matter an employer must be able to articulate a legitimate nondiscriminatory reason for discharging the employee in order to avoid an order of summary judgment in the plaintiff’s favor. (The threshold for establishing a prima facie case of discriminatory discharge is very low.) If an employer is able to articulate a legitimate nondiscriminatory reason for the termination of the plaintiff’s employment, then the plaintiff must produce evidence of the pretextual nature of the articulated reason for the dismissal in order to survive a motion for summary judgment.

Some courts have found that failure to follow established procedures is evidence of the pretextual nature of an employer’s legitimate nondiscriminatory reason for subjecting an employee to an adverse employment action. A former employee may also demonstrate that an employer’s legitimate nondiscriminatory reason for firing him or her is pretextual by showing that the articulated reason lacks credibility. Thus, if an employer gives an employee one reason for his or her termination at the time of the termination and testifies during deposition hearings that he or she was fired for another reason, the employee will no doubt introduce evidence of that inconsistency as evidence of the pretextual nature of the employer’s so called legitimate nondiscriminatory reason.

Warnings and Corrective Action

Nothing in the federal, state or local antidiscrimination laws requires an employer to warn an employee that misconduct and lack of performance will lead to termination. Likewise, nothing in the federal, state or local antidiscrimination laws requires an employer to document past misconduct or lack of performance prior to firing an employee. Nonprofit employers, like for-profit employers, should, however, always be aware of the jury factor: jurors expect employers to “Be Fair.” Jurors sometime consider a failure to warn or a lack of documentation as evidence that the reasons advanced for the termination of an employee are not the true reasons for the termination. If a juror does not believe the employer’s reasons for the termination, the juror may conclude that the employer’s “legitimate nondiscriminatory reason” for the termination is a pretext for unlawful discrimination.

In addition to the jury factor, today many employers, including nonprofit employers, have personnel policies that provide varying shades of “progressive discipline.” Progressive discipline plans generally provide that employees will receive oral counseling or written reprimands for all but the most serious infractions prior to termination. Employers who ignore the progressive discipline scheme expose their organizations to liability because, as noted above, courts allow plaintiffs to introduce evidence of failure to follow established procedures as evidence that an employer’s legitimate nondiscriminatory reason for an adverse employment action is pretextual in nature.

Chapter 61. Overtime Compensation

a. The Law

The FLSA defined in Chapter 59 establishes minimum wage, overtime pay, recordkeeping, and child labor standards affecting full-time and part-time workers in the private sector and in federal, state, and local governments. With regard to overtime compensation, the FLSA requires an employer to pay a nonexempt employee at a rate of at least one and one-half times the employee's regular rate of pay for each hour worked in a work week in excess of 40 hours. Employees who work for certain businesses or organizations (or "enterprises") are covered by the FLSA. These enterprises, which must have **at least two employees**, are:

- Those which do at least \$500,000 a year in business, and
- Hospitals, businesses providing medical or nursing care for residents, schools and preschools, and government agencies.

The WMWA also requires, among other things, that employers pay overtime for all hours worked over 40 in a work week. While the WMWA mirrors the requirements of the FLSA generally, in some respects the protections afforded employees under the WMWA are greater than those afforded employees under the FLSA. If both federal and state law covers an employer, the employer must comply with the law that is more generous to the employee.

b. Classifying Employees

(i) Classification of Exempt and Nonexempt Employees

By and large the most common mistake that employers make in the administration of wage and hour laws is misclassification of employees. Employers mistakenly misclassify employees who are covered under the provisions of the FLSA and the WMWA as exempt from the coverage of those laws. It is a very common mistake that can be very costly to employers.

To avoid this mistake, employers should start from the assumption that every employee is entitled to one and a half times his or her regular rate of pay for hours worked over 40 in a work week, and work backward from that starting point. That is because the FLSA was enacted in 1938, during the height of this country's Great Depression. The overtime premium of time and a half was designed to serve as a disincentive to employers who required employees to work over 40 hours in a work week rather than hiring additional employees. Or, in more positive terms, it was designed to serve as an incentive to employers to hire additional workers. In simplistic terms, the thinking was that if an employer was required to pay an overtime employee time and a half for the same hour that it could pay a new employee straight time, the employer would hire a new employee rather than requiring the current employee to work overtime. Given this statutory mandate, exemptions from the requirements of a law were narrow from their inception, and continue to be narrowly tailored.

(ii) The Big Three “White Collar” Exemptions

The most common exemptions under the FLSA and the WMWA are the so-called “white-collar” exemptions. They are also the most misunderstood exemptions. Bona fide executive, administrative, professional and computer employees are exempt from the overtime requirements of both the FLSA and the WMWA, but that leaves open the question of who is a bona fide executive, administrative or professional employee.

The FLSA does not define executive, administrative, or professional for purposes of the exemptions, but the U.S. Department of Labor (“DOL”) has promulgated administrative regulations defining the scope of the exemptions. As, the DOL recently acknowledged in a proposal to amend these regulations, the exemptions have long “engendered considerable confusion ... regarding who is, and who is not, exempt.”

The Department of Labor has a fact sheet that lists the tests which must be met to qualify for an employee exemption. See Dep’t of Labor, Fact Sheet #17A (rev. July 2008), available at http://www.dol.gov/esa/whd/regs/compliance/fairpay/fs17a_overview.pdf. The following summarizes such tests for qualifying an executive employee, professional employee, computer employee, administrative employee and a learned professional employee.

To qualify for the executive employee exemption, all of the following tests must be met:

- The employee must be compensated on a salary basis (as defined in the regulations) at a rate not less than \$455 per week;
- The employee’s primary duty must be managing the enterprise, or managing a customarily recognized department or subdivision of the enterprise;
- The employee must customarily and regularly direct the work of at least two or more other full-time employees or their equivalent; and
- The employee must have the authority to hire or fire other employees, or the employee’s suggestions and recommendations as to the hiring, firing, advancement, promotion or any other change of status of other employees must be given particular weight.

To qualify for the administrative employee exemption, all of the following tests must be met:

- The employee must be compensated on a salary or fee basis (as defined in the regulations) at a rate not less than \$455 per week;

- The employee’s primary duty must be the performance of office or nonmanual work directly related to the management or general business operations of the employer or the employer’s customers; and
- The employee’s primary duty includes the exercise of discretion and independent judgment with respect to matters of significance.

To qualify for the learned professional employee exemption, all of the following tests must be met:

- The employee must be compensated on a salary or fee basis (as defined in the regulations) at a rate not less than \$455 per week;
- The employee’s primary duty must be the performance of work requiring advanced knowledge, defined as work which is predominantly intellectual in character and which includes work requiring the consistent exercise of discretion and judgment;
- The advanced knowledge must be in a field of science or learning; and
- The advanced knowledge must be customarily acquired by a prolonged course of specialized intellectual instruction.

Id.

To qualify for the creative professional employee exemption, all of the following tests must be met:

- The employee must be compensated on a salary or fee basis (as defined in the regulations) at a rate not less than \$455 per week; and
- The employee’s primary duty must be the performance of work requiring invention, imagination, originality or talent in a recognized field of artistic or creative endeavor.

Id.

Caution: The exemption does not cover an employee who holds a professional degree but who performs a job that is not professional in nature or to which the degree he holds is not applicable.

A relatively recent addition to the “big three” white collar exemptions is the exemption for highly paid computer system analysts and programmers.

To qualify for the computer employee exemption, the following tests must be met:

- The employee must be compensated **either** on a salary or fee basis (as defined in the regulations) at a rate not less than \$455 per week or, if compensated on an hourly basis, at a rate not less than \$27.63 an hour;
- The employee must be employed as a computer systems analyst, computer programmer, software engineer or other similarly skilled worker in the computer field performing the duties described below;
- The employee’s primary duty must consist of:
 - 1) The application of systems analysis techniques and procedures, including consulting with users, to determine hardware, software or system functional specifications;
 - 2) The design, development, documentation, analysis, creation, testing or modification of computer systems or programs, including prototypes, based on and related to user or system design specifications;
 - 3) The design, documentation, testing, creation or modification of computer programs related to machine operating systems; or
 - 4) A combination of the aforementioned duties, the performance of which requires the same level of skills.

(iii) Working Employees “Off the Clock”

The definition of “employ” under the FLSA includes “to suffer or permit to work.” Consequently, if an employer allows a nonexempt employee to “volunteer” hours over 40 in a work week, or knows the employee is working the volunteer hours over 40, the employer must compensate the employee accordingly—even if the employee submits a time card that does not reflect the volunteer hours.

(iv) “Comp Time” Not Allowed

Of special interest to nonprofit employers, often short on resources and long on missions to accomplish, is the notion on compensatory time or “comp time” in lieu of compensation at the rate of time and a half the employee’s regular rate of pay. According to L&I regulations, the WMWA does not apply to an employee who requests compensatory

time (“comp time”) off work in lieu of overtime pay; however, the FLSA prohibits the practice for all except certain public sector employees such as firefighters.

Chapter 62. Employee Leave Laws

a. The Family and Medical Leave Act (the “FMLA”)

A private employer is covered by the FMLA if it employs 50 or more employees for each working day during each of 20 or more calendar workweeks in the current or preceding calendar year. The 20 workweeks need not be consecutive. According to the FMLA, private elementary and secondary schools are covered regardless of the number of employees they employ.

An employee of an employer “covered” by the FMLA is eligible for FMLA leave if three conditions are met at the time the leave commences:

- The employee has been employed by the employer for at least 12 months at the time the leave commences;
- The employee has been employed for at least 1,250 hours of service during the 12-month period immediately preceding the commencement of the leave; and
- The employee is employed at a work site where 50 or more employees are employed by the employer within 75 miles of that worksite.

If an employee is eligible for FMLA leave, the employee is entitled to take leave for any of the following reasons:

- For the birth of a child, and in order to care for a newborn child;
- For the placement with the employee of a son or daughter for adoption or foster care;
- To care for the employee’s spouse, child or parent with a serious health condition;
- Because of a serious health condition that makes the employee unable to perform one or more of the essential functions of his or her job (“essential functions” is defined according to the Americans with Disabilities Act); or
- Because of “any qualifying exigency” arising out of the fact that the spouse, son, daughter, or parent of the employee is on active military duty, or has been notified of an impending call to active duty status in support of a contingency operation.

According to U.S. Department of Labor FMLA regulations issued on November 17, 2008, an eligible employee may take FMLA leave while the employee’s spouse, son,

daughter, or is on active duty or call to active duty status for one or more of the following “qualifying exigencies”:

- **Short-Notice Deployment.** To address any issue that arises from the fact that a covered military member is notified of an impending call or order to active duty in support of a contingency operation seven or less calendar days prior to the date of deployment.
- **Military Events and Related Activities.** To attend any official ceremony, program, or event sponsored by the military that is related to the active duty or call to active duty status of a covered military member or family support or assistance programs and informational briefings sponsored or promoted by the military, military service organizations, or the American Red Cross that are related to the active duty or call to active duty status of a covered military member.
- **Childcare and School Activities.** To arrange for alternative childcare when the active duty or call to active duty status of a covered military member necessitates a change in the existing childcare arrangements, or to provide childcare on an urgent, immediate need basis, or to enroll a child in or transfer to a new school or day care facility when enrollment or transfer is necessitated by the active duty or call to active duty status of a covered military member; or to attend meetings with staff at a school or a daycare facility, such as meetings with school officials regarding disciplinary measures, parent-teacher conferences, or meetings with school counselors when such meetings are necessary due to circumstances arising from the active duty or call to active duty status of a covered military member.
- **Financial and Legal Arrangements.** To make or update financial or legal arrangements to address the covered military member’s absence while on active duty or call to active duty status; and to act as the covered military member’s representative before a federal, state, or local agency for purposes of obtaining, arranging, or appealing military service benefits while the covered military member is on active duty or call to active duty status, and for a period of 90 days following the termination of the covered military member’s active duty status.
- **Counseling.** To attend counseling provided that the need for counseling arises from the active duty or call to active duty status of a covered military member.
- **Rest and Recuperation.** To spend time with a covered military member who is on short-term, temporary rest and recuperation leave during the period of deployment.
- **Post-Deployment Activities.** To attend arrival ceremonies, reintegration briefings and events, and any other official ceremony or program sponsored

by the military for a period of 90 days following the termination of the covered military member's active duty status.

- **Death of a Covered Service Member.** To address issues that arise from the death of a covered military member while on active duty status.
- **Additional Activities.** To address other events that arise out of the covered military member's active duty or call to active duty status provided that the employer and employee agree that such leave shall qualify as an exigency and agree to both the timing and duration of such leave.

Under the FMLA an eligible employee of a covered employer is also entitled to up to 26 weeks of leave in a single 12-month period to care for a spouse, son, daughter, parent, or next of kin who is a covered service member recovering from a serious illness or injury sustained in the line of duty while on active duty. To be a "covered service member," the relative must:

- Be a member of the armed forces, National Guard, or reserves;
- Suffer from an illness or injury incurred on active duty that *may* render him or her medically unfit to perform the duties of his office, grade, rank, or rating (i.e., a "serious injury or illness"); and
- Must be undergoing medical treatment, recuperation, or therapy, be in outpatient status, or be on the temporary disability retired list as a result of the serious injury or illness.

FMLA military caregiver leave is available during "a single 12-month period" during which an eligible employee is entitled to a combined total of 26 weeks of all types of FMLA leave. This provision of the FMLA became effective January 28, 2008.

b. Washington Family Leave Act

In 2006, the Washington state legislature amended the Washington Family Leave Act ("WFLA") to include job protection and leave benefits similar to those provided under the FMLA. The amended statute expressly provides that leave under the WFLA and the FMLA "is *in addition to* any leave for sickness or temporary disability because of pregnancy or childbirth." *See* RCW 49.78.390.

This new legislation extends the benefit of increased time off for disability due to pregnancy and childbirth to more employees by reducing the threshold number of employees for a covered employer from 100 employees to 50 employees (each working day during each of 20 or more calendar workweeks in the current or preceding calendar year). The legislation also reduces from 1,820 hours to 1,250 hours the number of hours an employee must have worked during the twelve months prior to the requested leave in order to qualify for leave.

c. Washington Law Against Discrimination

Regulations promulgated by the Washington State Human Rights Commission under the gender discrimination prohibitions of the WLAD also require covered employers to grant female employees leave for sickness or disability due to pregnancy or childbirth. (*See* WAC 162-30-020(4)(a) (“An employer shall provide a woman a leave of absence for the period of time that she is sick or temporarily disabled because of pregnancy or childbirth. Employers must treat a woman on pregnancy related leave the same as other employees on leave for sickness or other temporary disabilities.”). As noted above, the WLAD covers employers 8 or more employees.

d. Washington Military Family Leave Act

The Washington Military Family Leave Act (“WMFLA”) (*see* RCW 49.77) became effective on June 12, 2008. The law allows an employee whose spouse is a member of the United States armed forces, National Guard, or reserves who has been notified of an impending call or order to active duty, or who has been deployed, or who is on leave from deployment, a total of 15 days of unpaid leave per deployment.

Under the WMFLA, an employee whose spouse is being called into active duty for the armed forces or who will be, or is, deployed during a period of military conflict, is entitled to up to 15 days of unpaid leave of absence from work. The employee may take the 15 days of leave before the deployment of the military spouse or when the military spouse is on a leave from the deployment. For each new deployment of the military spouse, the employee may take another family military leave of up to 15 days.

The employee must give notice to his or her employer of the intent to take the family military leave within five business days of receiving official notice of the call or order to active duty or deployment, or within five business days of official notice of the military spouse’s upcoming leave from the deployment. To be eligible, the employee must work an average of at least 20 hours per week for the employer. Family military leave is only available during a period when Congress has declared war, the President has declared war by executive order, or military reserves have been called to active duty. The law covers any employer with one or more employees.

e. Washington Domestic Violence Leave Act

The Domestic Violence Leave Act was signed into law on April 1, 2008, and became effective immediately. *See* Chapter 49.76 RCW. This law provides leave for employees who are victims of domestic violence, sexual assault, or stalking. The law also allows for leave for an employee with a family member (child, spouse, parent, parent-in-law, grandparent, or person with whom the employee has a dating relationship) who is a victim of domestic violence, sexual assault, or stalking. Domestic violence/sexual assault leave may be taken in blocks or intermittently, and the amount of leave that an employee may make take is restricted to a “reasonable” amount, but is not specifically limited as to time or length under the law.

Leave under this act may be taken for the following purposes:

- To seek law enforcement or legal assistance or to prepare for or participate in any legal proceeding related to domestic violence, sexual assault, or stalking;
- To seek health care treatment for physical or mental injuries from domestic violence, sexual assault, or stalking, or attend to such health care treatment for a family member;
- To obtain (or assist a family member in obtaining) services from a domestic violence shelter, rape crisis center, or other social services;
- To obtain (or assist a family member in obtaining) mental health counseling related to domestic violence, sexual assault, or stalking; or
- To participate in safety planning, to temporarily or permanently relocate, or to take other actions to increase the safety of the employee or family member relating to domestic violence, sexual assault, or stalking.

Employees must give notice to their employers of the need for this leave no later than the end of the first day the employee takes the leave. Employers may require verification to support the need for the leave, which can take the form of police reports, court documents, or the employee's own written statement of the need for the leave. The law covers any employer with one or more employees.

f. Washington Family Care Act

In 2002, the Washington state legislature enacted a relatively unique law that enables an employee to use his or her choice of sick leave or other paid time off to care for:

- A child of the employee with a health condition that requires treatment or supervision; or
- A spouse, parent, parent-in-law or grandparent of the employee who has a serious health condition or an emergency condition.

An employee taking leave under the Washington Family Care Act must comply with the terms of collective bargaining agreements or employer policies applicable to the leave, except for any terms relating to the choice of leave. The law covers any employer with one or more employees. The eligibility requirement for employees is current employment.

Chapter 63. Employee Handbooks

a. Should You Have One?

An employee handbook is a compilation of policies and procedures that an employer decides it wants to use in running its business and wishes to communicate to its employees. There are many positive reasons to have an employee handbook and few negative ones, provided the handbook is properly written. An employee handbook allows you to communicate policies and procedures in a comprehensive and consistent way. It helps to

ensure that all employees receive copies of important policies such as sexual harassment policies. Having employees sign a receipt for the handbook provides an efficient method to document employee receipt of all pertinent policies and procedures.

There is one significant concern about having an employee handbook. In Washington, unless otherwise agreed by the employer and employee, all employees are considered to be “at will” employees. This means the employee may resign at any time for any or no reason, and the employer may discharge the employee at any time for any or no reason. In other words, an employer does not have to have a reason to discharge an “at will” employee. Courts have held that in certain limited circumstances an employee handbook could create a contract between the employee and employer that might prevent the employer from discharging the employee except for reasons set out in the handbook.

b. Preserving the “At Will” Employment Relationship

To preserve the “at will” employment relationship, employee handbooks should not promise employees specific treatment in specific circumstances. Such handbooks should not state that employees may be discharged or disciplined only “for cause” or “just cause” or after a certain process or procedure. The handbook should not give any guarantee of employment, such as by stating or suggesting that employment is “permanent,” is “guaranteed,” or will last for any particular period of time. Each employee handbook should contain a prominent disclaimer that states that the employee expressly agrees and understands that the employee handbook and all provisions in the handbook are general guides and are not a contract or an assurance of continued employment. The disclaimer should include a statement that the employee acknowledges and understands that his employment is at will. The disclaimer should define the term “at will.” The disclaimer should also state that the employee understands the employer may change the handbook and its provisions at any time. If there was a previous handbook or set of policies, the disclaimer should state that such handbook is no longer in effect. Finally, it should be expressly stated which management person has the authority to change an employee’s at will status and that this may only be done by specific written agreement. It is recommended that an employer have each employee read, sign and date the disclaimer.

c. Matters to Include in an Employee Handbook

The following matters are suggested employer policies and procedures to include in an employee handbook:

- Employment at will status;
- Equal employment/nondiscrimination policies;
- Harassment policy and specific complaint procedures;
- Work hours, lunch period, rest breaks, flextime policies;
- Overtime eligibility, authorization and reporting;

- Policies and procedures relating to use of vacation, sick leave, bereavement leave, military leave, jury duty, etc.;
- Procedures for using family and medical leave (if applicable);
- General employee conduct policies including attendance, use of alcohol and drugs, nonexclusive examples of conduct that may result in discipline, and nonexclusive examples of the types of discipline that may be imposed;
- General descriptions regarding the availability of employee benefits (medical and dental insurance, life insurance, disability insurance and retirement plans);
- Holidays that are observed;
- Safety policies;
- Emergency procedures;
- Employee use of employer email and Internet access; and
- Employee use of employer phones and other equipment.

Chapter 64. Other Obligations of an Organization With Respect to Employees

a. Federal Requirements

(i) EIN

An employer identification number (“EIN”), also known as a federal employer identification number (“EIN”), is used to identify the tax accounts of all employers, including nonprofit organizations. Employers are required to use the EIN on all of the items that the employer sends to the IRS and the Social Security Administration.

(ii) Verification of Worker Identity and Eligibility to Work

Employers are required to verify that each new employee is legally eligible to work in the United States. This includes completing the U.S. Citizenship and Immigration Services (“USCIS”) Form I-9, Employment Eligibility Verification. Employers can obtain this form from USCIS offices or by visiting the USCIS website at <http://www.uscis.gov>. Employers must maintain completed Forms I-9 in their files for three years after the date of hire or one year after the date employment ends, whichever is later.

(iii) Federal Income Tax Withholding and Social Security Contributions

Employers are required to pay Social Security and Medicare taxes (commonly referred to as “FICA taxes”) on income paid to their employees. An employer is required to pay 6.2% in Social Security tax and 1.45% in Medicare tax on each employee’s gross earnings (up to specified amounts). The employee must contribute the same amount. And

while many nonprofit organizations are exempt from federal corporate income tax under § 501(c)(3) of the Code and thus do not have to pay federal corporate income tax themselves, they must still withhold federal income tax from the pay of their employees.

It is extremely important to properly withhold and timely deposit the employee's and employer's share of taxes owed. Failure to make such deposits will subject the employer to civil fines and penalties, and possibly criminal liability. In addition to making the required deposits, employers are required to complete a federal tax return showing the amounts withheld and deposited. This tax return, called a Form 941, must be timely completed and filed with the IRS. Failure to file the form or late filing will result in civil penalties. For more information on payment, withholding and filing requirements, *see* IRS Publication 15 (2008), (Circular E), Employer's Tax Guide, at <http://www.irs.gov/publications/p15>, and IRS Publication 15-A, Employer's Supplemental Tax Guide, at <http://www.irs.gov/pub/irs-pdf/p15a.pdf>.

(iv) Federal Unemployment Taxes (“FUTA”)

Employers also are required to pay FUTA for each employee. The employer pays the full amount of this tax and may not deduct any portion of the tax from his employee's wages. An employer that is exempt from income tax under § 501(c)(3) of the Code is also exempt from FUTA. For more information requirements, *see* IRS Publication 15 (2008), (Circular E), Employer's Tax Guide, at <http://www.irs.gov/publications/p15>, and IRS Publication 15-A, Employer's Supplemental Tax Guide, at <http://www.irs.gov/pub/irs-pdf/p15a.pdf>.

b. State Requirements: Workers' Compensation and Unemployment Compensation

In Washington, employers must complete a Master Business Application with the State of Washington. See Chapter 9. The application allows an employer to obtain a business license and register with all state agencies for which registration is required. By completing the Master Business Application an employer registers for workers' compensation with the Department of Labor and Industries and unemployment insurance with the Employment Security Department, and both agencies will send you information about employee quarterly report forms. Depending on the nature of the organization's activities, an employer may also need to register with the city or county in which it is conducting its business. *See* <http://www.dol.wa.gov/business/hire.html> for additional information.

PART XI. INTELLECTUAL PROPERTY CONSIDERATIONS

Chapter 65. Application of Intellectual Property Law to Nonprofits

Intellectual property can be a very detailed and esoteric topic, but here we will only focus on a few intellectual property issues that nonprofit corporations commonly encounter. Before doing that, however, we will generally describe four basic types of intellectual property: patents, copyrights, trademarks, and trade secrets.

Patents are a form of protection with three categories: utility, design, and plant. In general, (i) utility patents protect new and useful machines, manufactured goods, processes, or compositions of matter, and any improvements to any of the foregoing; (ii) design patents protect original and ornamental designs for a manufactured good, and (iii) plant patents protect distinct and new varieties of plants. Although there are some nonprofit corporations that may be very involved with patents (such as university foundations or hospitals), most nonprofit corporations will not be involved with applying for or obtaining patent rights, so we will not discuss them here. If interested, a nonprofit corporation can obtain more information on patents from the patent section of the U.S. Patent and Trademarks Office website at <http://www.uspto.gov/main/patents.htm>.

Copyrights are a form of protection that protect “original works of authorship”. Items protected by copyright include written text (such as books and articles), photographs, videos, drawn pictures (including designs and logos), music, and computer software. A copyright owner can prevent a third party from, among other things, copying, distributing, or creating derivatives of the work. As soon as a nonprofit corporation’s employee creates an original work the nonprofit corporation has a copyright in it—nothing more needs to be done. However, additional rights can be obtained by registering the copyright with the U.S. Copyright Office. Also, a copyright must be registered in order to sue a third party for infringement of such copyright. More information on copyrights and how they may be registered is available from the website for the U.S. Copyright Office at <http://www.copyright.gov/>. See Chapter 67 for discussion of an issue that often arises with respect to copyright ownership.

Trademarks are logos, business or product names, tag lines, designs, or other items that identify the source of origin for a good. Similarly, a service mark is like a trademark except that it identifies the source of origin for a particular service rather than a particular good. For ease of discussion, any reference to “trademarks” in this Part will mean both trademarks and service marks. A nonprofit corporation has a potential claim against any third party that subsequently uses the same or similar trademark in such a way that people are likely to be confused between the nonprofit corporation and such third party and/or their respective goods or services. Since every nonprofit corporation probably has one or more trademarks, a more detailed explanation of trademarks is set forth in the following Chapter.

A trade secret is any information that derives economic value from not being known (e.g., product formulas, detailed information on suppliers or customers, ways of doing business, etc.). A nonprofit corporation has a potential claim against a third party that acquires or uses its trade secret without consent. In order to show that something is a trade

secret, a nonprofit corporation must show that the information was secret and that reasonable efforts were made to keep it secret. Such efforts will probably include having employees and contractors sign a confidentiality agreement (see sample agreements available online at <http://www.waaco.org>).

Chapter 66. Trade Names and Trademarks

There is often some confusion surrounding the difference between a trade name and a trademark. A trade name is the name of the business, but a trade name is usually also a trademark because it indicates the source of origin for the goods or service provided by the business. For example, Microsoft Corporation is a trade name, and “Microsoft” is also a trademark.

Rather than trying to understand the differences between a trade name and a trademark, it is easier if a nonprofit corporation just assumes its trade name will also function as a trademark and picks a trade name with trademark law in mind.

Under trademark law, a nonprofit corporation can be sued for trademark infringement if it uses a trademark that is the same as the trademark of another entity or is so similar that people are likely to confuse the nonprofit corporation and the other entity and/or their respective goods and services. Thus, if a nonprofit corporation begins using a business name without conducting any prior research and later finds that there is another entity with senior rights in the same or a similar name, the nonprofit corporation may have to change its name, reprint materials, change signage, and incur other expenses.

In order to avoid this, it is important for a nonprofit corporation to do some preliminary research before finally deciding on a business name. This usually involves at least three things: (i) searching the database available at the U.S. Trademark Office website, (ii) performing some general searches using the Internet, and (iii) investigating to see whether an appropriate domain name is available.

Initially, a nonprofit corporation should go to the U.S. Patent and Trademark Office’s trademark site at <http://www.uspto.gov/main/trademarks.htm>. The site allows the nonprofit corporation to use the Trademark Electronic Search System (TESS) to see whether a particular trademark has been applied for or registered. The site also contains various background information related to trademarks.

If TESS does not indicate that the same or a similar trademark has been applied for or registered, a nonprofit corporation should then conduct additional searches on Bing, Google or other Internet search engines and online telephone directories to see if an entity with the same or a similar name already exists.

Finally, since a nonprofit corporation will probably want a website, it should see if an appropriate domain name is available. This can be done at sites such as <http://www.OfficeLive.com>, <http://www.SmallBusiness.Yahoo.com>, and <http://www.GoDaddy.com>.

A nonprofit corporation should be forewarned that it is often very difficult to find an appropriate business name/trademark (so much so that in 2007 this difficulty was the subject

of a Dilbert cartoon). At times, it may be very frustrating because all the desired choices will seemingly be taken. A nonprofit corporation can increase its chances of finding a suitable name by choosing arbitrary or fanciful terms (e.g., made-up words like “Dasani” or real words like “Apple” that have no connection to the good or service).

After completing the above searches and identifying a few potential names that seem to be available, a nonprofit corporation should strongly consider consulting with an experienced attorney. The attorney may point out problems that were not otherwise obvious or may indicate that a situation that appeared risky to the nonprofit corporation is not very problematic. In any event, it is best to have several alternative names to discuss with the attorney. Nonprofit corporations should avoid becoming too “attached” to one name before conducting the above investigations. It can be a frustrating and expensive lesson for a nonprofit corporation to launch a new business without the proper investigation and subsequently receive a “cease and desist” letter from a prior user that forces the nonprofit corporation to change its name and all related material that contained the old name.

It should be emphasized that the analysis of whether a nonprofit corporation’s proposed name may have potential problems is an art rather than a science and requires experience in this area. A nonprofit corporation may have a problem even if its name is not identical to another entity and even if the nonprofit corporation successfully registers a Washington State trade name and a Washington State trademark. Thus, it is highly recommended that an experienced attorney assist with this analysis.

The above research can be done while the nonprofit corporation’s articles of incorporation are being prepared, and the eventual name chosen can be inserted prior to the articles of incorporation being filed. Once the articles of incorporation are filed, a Washington Master Business Application must also be filed (as discussed in Chapter 9). The Master Business Application contains a section where the nonprofit corporation can register its trade names. Although it may not be mandatory, this section should be used to register the nonprofit corporation’s trade names because registration by this method is inexpensive and can be done simultaneously with filing the other information initially required by the Master Business Application. Usually the nonprofit corporation’s corporate name is also a trade name. In some cases, the acronym of a nonprofit corporation’s corporate name may also be an additional trade name. For example, the acronym “ACLU” may be an additional trade name for the American Civil Liberties Union. As noted above, these trade names are also usually trademarks.

Applicable law permits nonprofit corporations to accrue rights in a trademark as soon as the trademark is used in commerce in connection with the nonprofit corporation’s business. For example, the trademark might be used on websites, in circulated pamphlets, or in seminar or conference materials. However, additional protection can be obtained, and is usually desirable, by registering the trademark under state and/or federal laws.

A nonprofit corporation may register a Washington State trademark by submitting an application to the Washington Secretary of State along with the appropriate fee. A copy of the application for state registration can be obtained at http://www.secstate.wa.gov/corps/registration_forms.aspx#TRADEMARKS. State trademark

registration may prevent other entities with similar goods or services from subsequently obtaining a Washington State registration for the same mark, because either the registered trademark will be included in searchable databases and will discourage other parties from filing for such mark, or the Secretary of State may refuse to register a similar mark for similar goods or services.

Nonprofit corporations may obtain more expansive trademark rights by registering the trademark at the federal level with the U.S. Patent and Trademark Office. The application for this registration is now usually submitted online from the U.S. Patent and Trademark Office website at <http://www.uspto.gov/main/trademarks.htm>. While federal trademark registration is always recommended, the costs for such registration are more substantial than for state registration, and the application review process is more rigorous and time-consuming. Therefore, whether a nonprofit corporation should in fact undertake federal registration requires a cost/benefit analysis that depends on the corporation's resources and goals. A knowledgeable attorney can help the nonprofit corporation with this decision.

Trademark registration serves at least two purposes. First, from a “defensive” perspective, trademark registration helps ensure that no other entity may force a subsequent change in the nonprofit corporation's trade name or trademark. Second, from an “offensive” perspective, trademark registration may increase the ability of a nonprofit corporation to enforce its rights against infringers of its trademark.

Unfortunately, there usually is no government agency or private party charged with enforcing a nonprofit corporation's trade name or trademark rights. Thus, a nonprofit corporation will bear the costs of such action. Such enforcement may require the corporation to hire an attorney and may be relatively expensive and thus not a viable option. For many nonprofit corporations with limited resources, it will be important to remember that, although conducting searches and registering trade names and trademarks will increase the likelihood that they cannot be forced to stop using their trademarks, there is no guarantee that another party will not use a similar trademark or that such other party can be easily forced to stop such use.

Chapter 67. Ownership of Intellectual Property

There are many complicated rules regarding the ownership of intellectual property, and a nonprofit corporation should seek the assistance of an attorney if it has any specific questions or if it is in a field that uses or develops intellectual property extensively. In general, a nonprofit corporation should have a written agreement with each of its employees and independent contractors regarding who owns the intellectual property they may create. There is a somewhat counterintuitive rule of law that holds that if a nonprofit corporation does not have an agreement with an independent contractor regarding the transfer of intellectual property ownership, then the intellectual property such independent contractor creates (such as a brochure, a logo, or a website) might be owned by the independent contractor—even if the nonprofit corporation paid the independent contractor to create it.

It can be very surprising for a nonprofit corporation to find that it may not be able to freely modify and redistribute a brochure or website that it paid for because it did not have a

proper intellectual property assignment from the independent contractor who created it. Moreover, an “independent contractor” in this case is not just an unrelated design firm or website developer; it might be anyone that the nonprofit corporation does not provide employee benefits to or pay social security taxes for. Thus, “volunteers” or “interns” who spend time at the nonprofit corporation on a regular basis will probably fall within this category and will be considered independent contractors, and thus they should sign intellectual property assignments.

It is best to have a custom intellectual property agreement created for each specific situation, but often a nonprofit corporation does not have the time or money to have one drafted. Thus, the following three simple sample agreements which are available online at <http://www.waaco.org>, may be useful:

- The sample independent contractor agreement is a letter agreement for a situation when a nonprofit corporation hires an independent contractor to perform some services (such as creating a brochure or logo). It includes language that transfers the intellectual property created to the nonprofit corporation and also includes a confidentiality provision so that the independent contractor has an obligation to protect the nonprofit corporation’s trade secrets. Independent contractor agreements can of course be much more complicated and contain many other provisions. This Exhibit A is just a very simple template.
- The sample assignment agreement is an agreement that could be signed by all new employees as a condition of being hired. By signing the agreement the new employee expressly assigns all intellectual property to the nonprofit corporation and also agrees to protect the nonprofit corporation’s trade secrets (as noted above, in order to bring a trade secret misappropriation case, a nonprofit corporation will need to show that it took reasonable efforts (such as entering into these types of agreements) to protect its trade secrets). If a nonprofit corporation would also like existing employees to sign an assignment agreement such as this, it should carefully discuss the situation with an attorney. The nonprofit corporation may have to do additional things to better ensure that the agreement can be enforced against existing employees.

The sample assignment agreement described above can also be signed by independent contractors who have not signed an independent contractor agreement. Note that the sample assignment agreement does not have a description of services, deadlines, and other provisions that the sample independent contractor agreement has, and thus it may be more suitable for volunteers, consultants, interns and other individuals who are not employees of the nonprofit corporation but who provide assistance without being retained for a specific project.

- The sample release agreement is for a situation when a nonprofit corporation is creating a training or educational video, is taking photos of people that it

would like to use, or is otherwise involved in a project where many people are involved and it is too cumbersome to have them sign something like the sample independent contractor agreement or the sample assignment agreement. Ordinarily, a nonprofit corporation might use a “model’s release” for this type of situation, but the sample release agreement is designed to be a model’s release, plus a release for anyone else that is involved in the production (for example, directors, producers, photographers, crew members or anyone else who is seen in, or helps with the creation of, the work should sign the release since they all potentially will have intellectual property rights in the work). The sample release agreement should be modified to fit the particular situation, and if any of the people involved are minors, the form should be signed by their parents or legal guardians.

* * * * *

As with other sections of this Handbook, this Part on Intellectual Property has only provided a very brief and simplified description of some of the issues that a nonprofit corporation might face. It has described how certain things might be done by a nonprofit corporation in a relatively independent and inexpensive manner. Unfortunately, “one size fits all” advice and form agreements can never cover all the potential issues, so it is always best for a nonprofit corporation to consult with a knowledgeable attorney.

PART XII. PERSONAL INFORMATION SECURITY AND ONLINE PRIVACY ISSUES FOR NONPROFIT ORGANIZATIONS

Chapter 68. Personal Information Security

Almost every organization collects personal information from individuals, whether from employees, volunteers, donors, or recipients of services. This personal information may be necessary or useful for your organization’s activities, such as payroll processing and sending solicitation requests. Use of personal information, however, comes with responsibilities to keep that data safe. Sensitive information such as social security numbers, credit card numbers, financial account numbers, date of birth, health information and other data can be used to commit financial fraud and identity theft.

To protect individuals against such threats, federal laws and many states require organizations to protect personal information and in some cases to notify individuals if information is improperly disclosed. Note that this Chapter is intended to cover only commonly applicable personal information security guidelines and requirements. Not all data protection laws are covered here. In particular, if you handle financial information, health information, driver’s license numbers and social security numbers, other laws and regulations may apply.

a. Protecting Information

The Federal Trade Commission (“FTC”) and a few states outside of Washington specifically require organizations to take measures to protect information. Under Section 5 of the Federal Trade Commission Act, 15 U.S.C. §§ 41-58, the FTC has instituted numerous actions against entities who failed to adequately secure personal information, including at least one nonprofit corporation. Of the states that have data protection laws, most prescribe broad requirements to “reasonably secure” sensitive personal information. Massachusetts has enacted very detailed security regulations covering sensitive personal information, including encryption requirements (*see* 201 Mass. Code. Reg. 17.00—effective March 1, 2010). Nevada also has enacted specific encryption requirements for sensitive personal information sent electronically or stored on mobile devices. *See* NRS 603A—effective January 1, 2010.

This section gives a general overview of what your organization can do to help protect and secure personal information. Additional tips and guidance can be found on the FTC’s website at <http://www.ftc.gov/infosecurity/>.

(i) Data Minimization

Your organization can best protect information by not having it in the first place. You can avoid collecting information that you do not really need, such as by eliminating unnecessary fields in forms. You can reduce the amount of data you have by storing information in redacted or truncated form, for example, by using only the last four digits of credit cards in databases. You can also delete information that you no longer need.

(ii) Securing Data

Data in physical form is a common source of identity theft. Keep physical documents safe by limiting access to areas where personal information is kept to only those individuals who have a legitimate “need to know.” Require employees and volunteers to lock documents containing sensitive data in file cabinets or drawers for storage.

Protection of data in electronic form is best handled by information technology personnel and professionals with expertise in data security. Every individual in your organization, however, should know what they can do to help keep electronic data secure. For example, avoid storing sensitive data on portable devices such as CDs, DVDs, USB flash devices, laptops, and phones. Strongly consider encrypting data you must keep on such portable devices and, if practical, any place you store sensitive data. At minimum, use some form of security technology using strong password protection. Encrypt sensitive data you send over the Internet, including by email. Make sure web pages that collect sensitive information over the Internet use SSL (short for Secure Sockets Layer) security. (You can tell if a site is secure by looking for the “s” after “http.” If the webpage URL starts with “http” it is not secure. If it starts with “https,” SSL security is used.) Use and regularly update firewalls, antivirus and antispymware software to protect systems and computers connected to the Internet.

Finally, make sure that vendors you use also protect any personal information you allow them to process or store on your behalf. You may be held responsible for the actions of your vendors. You should require them to notify you of any breaches and consider reserving the right to audit their activities.

(iii) Data Disposal

Many state laws, including Washington’s Chapter 19.215 RCW, specifically require that you properly dispose of sensitive data. In Washington, covered sensitive data includes financial information and health information. Information that is improperly disposed of can end up in the hands of dumpster divers or other types of identity thieves. Under Washington law, proper destruction involves “shredding, erasing, or otherwise modifying personal information in records to make the personal information unreadable or undecipherable through any reasonable means.” Make sure your workers shred or properly incinerate any paper documents. Disposal in recycling bins is not a secure way to dispose of documents. When disposing of old computer equipment, wipe the hard drives of data using appropriate wiping utility programs. If such technology is not economically feasible, you can also remove the hard drive and physically destroy it by simply smashing it.

b. Security Breach Notification

Laws in several states, including Washington’s Chapter 19.255 RCW, require your organization to notify individuals in the event of a data security breach. The laws in each state vary, but many are similar to Washington’s.

Washington’s breach notification law requires notification where there has been a breach of computerized data in the form of a name in combination with sensitive information

such as social security number, credit card data, financial account number and driver's license number. Some states also require notification where the compromise involves paper data. Some also add other data elements such as date of birth, medical information, or mother's maiden name.

Washington requires notification in the form of a physical writing to the affected individuals. Organizations may provide substitute notice by publication or email in the event of larger breaches. Washington, like many states, also requires notification to major credit reporting agencies in the event of breaches of a certain size. A few other states also require reporting to consumer protection agencies.

Other requirements and certain exceptions apply under the notification laws. Notably, Washington and most other states do not require notification when the lost or stolen data has been encrypted. If you have the type of data that could trigger notification, keeping that data encrypted could help you avoid the requirements under these laws.

Informational guides summarizing the various state laws and outlining a step-by-step process for responding to data security breach incidents are available at <http://www.perkinscoie.com/clientsecuritybreach/>. Because timing of notifications is usually an element under state laws and commonly the subject of investigation by state agencies, one of the most important things for an organization to do in the event of a breach is to act quickly to respond to a breach and notify individuals as soon as possible.

Chapter 69. Internet Advertising and Privacy Laws

The Internet has become an important tool for nonprofit organizations that allows nonprofits to more easily solicit donations, publish information via websites, provide e-newsletters to members, and much more. At the same time, nonprofit organizations must comply with important laws governing Internet advertising and privacy as well as ensure that any online solicitations comply with state and federal regulations.

One of the most important things all nonprofit organizations should do is to embrace transparency and accountability. Today, donors are using the Internet to keep tabs on the charities they support and to find out more about the ones they are thinking about supporting. Make it easy for them by ensuring that all relevant data about your organization is easily accessible. If your organization files a Form 990 or has an annual audited financial statement, consider making this information available on your website or providing a direct link to your GuideStar (or similar) listing.

The Internet allows us to obtain a wealth of information about consumer behavior when visitors utilize a website, purchase items, or make online donations. Any website can easily obtain consumer information by simply monitoring the visitors to the website, collecting reactions to ads placed on other websites, or adding members to your distribution lists. Types of information obtainable include how many people viewed your ad, what percentage of people clicked on the ad, what percentage of people purchased your product after seeing the ad, which pages on your website are visited most often, the names of other

websites your customers have visited, and customers' email addresses and other personal information.

On one hand, this data allows you to better serve your visitors, target your message, and simplify the experience for users of your website. On the other hand, misuse of all this information can potentially lead to fraud, violations of consumer privacy, or identity theft. As a result, consumers are increasingly wary of providing personal information, and more laws are being passed to protect their rights.

a. General Legal Requirements

Even before the ascendancy of the Internet, privacy laws had been passed by the U.S. government to protect the privacy of consumers' personal information and shield consumers from fraudulent, deceptive, or misleading advertising practices. These same laws apply to the Internet.

The FTC publishes guidelines to help businesses apply these laws to practices on the Internet. Specifically, the FTC has published "Advertising and Marketing on the Internet: Rules of the Road" (available at <http://www.ftc.gov/bcp/edu/pubs/business/ecommerce/bus28.shtm>).

This publication has a simple message for all Internet advertisers: "Advertising must tell the truth and not mislead consumers. In addition, claims must be substantiated." The FTC recommends that businesses and organizations:

- Place disclosures on the same webpage as the claim they apply to, and when necessary, provide adequate visual cues to indicate that a consumer must scroll down on the page to view the disclosure;
- When hyperlinking to disclosures, make the link obvious and noticeable, label the link accurately and indicate its importance, place the link near relevant information, ensure that the link takes consumers directly to the disclosure, and monitor link usage to ensure its effectiveness;
- Display disclosures prior to purchase or prior to donation; and
- Ensure that an advertisement's "text, graphics, hyperlinks, or sound do not distract consumers' attention from the disclosure."

If you sell other companies' products on your website, be aware that the FTC can also hold you responsible for misleading ads and product descriptions, even when those materials are provided by the manufacturer.

b. Children's Online Privacy Protection Act

If your nonprofit organization collects information from or is attractive to children under thirteen, you should be aware of the Children's Online Privacy Protection Act, which requires that businesses and organizations "obtain verifiable parental consent for the collection, use, or disclosure of personal information from children." 15 U.S.C.

§ 6502(b)(1)(A)(ii). Even if your site is not targeted at children, you could be subject to requirements under this law if you collect age or date of birth information during online registration and do not block children from registering.

c. Health Insurance Portability and Accountability Act (“HIPAA”)

If your nonprofit organization is a hospital or its foundation, you must be aware of HIPAA. Specifically, in the case of healthcare fundraising, hospitals cannot target segmented fundraising mail to former patients without their express written consent. For instance, if a person goes into the hospital as a cardiac patient, the hospital’s fundraiser or foundation cannot target that former patient as having been in the cardiac care unit without his or her written permission.

d. Your Organization’s Privacy Policy

(i) Online Privacy Protection Act (California State Law)

Owners of websites anywhere in the country should be aware of the provisions of California’s Online Privacy Protection Act of 2003 (codified in Cal. Bus. Code §§ 22575-22579), which went into effect July 1, 2004. It requires an owner of a commercial website or online service (“operator”) that collects personally identifiable information through the Internet about individual California resident consumers to conspicuously post its privacy policy. An individual’s personally identifiable information includes his or her name, address, email address, phone, social security number, identifying information that enables physical or online contact with such individual, and other information collected and maintained in personally identifiable form in combination with the preceding identifiers. An individual nonprofit organization’s website collecting such information may or may not be regarded a commercial website. Some important factors may be whether the organization’s website promotes any unrelated business activities, includes any paid advertising, or solicits new members who may receive in return for their dues some commercial benefit not related to the organization’s exempt purpose. Accordingly, an organization should carefully consider whether it would be advantageous to comply with the Online Privacy Protection Act’s requirements.

Under the Online Privacy Protection Act, the privacy policy must do the following:

- Identify the categories of (a) personally identifiable information collected through the website or online service about individual consumer visitors and (b) third-party persons or entities with whom the operator may share such information.
- Provide a description of the process for an individual consumer to review and request changes to his or her personally identifiable information collected through the website or online service, if the operator maintains such a process.
- Describe the process by which the operator notifies consumers who use or visit its website or online service of material changes to the operator’s privacy policy.

- Identify its effective date.

(ii) Preliminary Considerations in Drafting Your Privacy Policy

All organizations should consider developing a privacy policy for their organization. A privacy policy:

- Explains to individuals how your organization will collect, use, and secure any information you obtain about them.
- Demonstrates a level of responsibility to your members and donors, forming a bond of trust that will increase their confidence in you and willingness to do business with you.
- Helps your organization meet legal requirements.
- Functions as a guideline for making business and organizational decisions.

Following is a summary of the FTC's recommendations for a privacy policy:

- Notify individuals about your website's information collection policies.
- Allow individuals to choose how your organization uses any information you collect that personally identifies them.
- Give individuals a mechanism for reviewing the information you collect about them.
- Ensure the security of all personal information that your organization collects.

Several organizations can assist your organization by recommending privacy policies and security technologies, reviewing your privacy practices, and providing endorsements. One of the most respected is TRUSTe (<http://www.truste.org>), an independent, nonprofit organization established to safeguard Internet privacy and security.

The FTC's own privacy policy, available at <http://www.ftc.gov/ftc/privacy.htm>, may serve as a model, and a sample privacy policy can be found at the TRUSTe site at http://www.truste.org/docs/Model_Privacy_Policy_Disclosures.doc. Before using any sample privacy policy, review it carefully and understand your organization's practices to make sure the policy accurately reflects what your organization is really committed to doing.

There are certain pieces of key information to be included in your privacy policy. Once you have established this policy, it should be posted on your website and shared with any individual involved with your organization (including consultants or contractors).

(iii) What Information Is Collected and How

Your privacy policy should clearly state what consumer information you collect from anyone who visits your website (or communicates with your organization in any other manner). There are two broad types of consumer information:

- Personally identifiable information (“PII”) is the most sensitive because it can be used to identify an individual. PII includes a person’s legal name, email address, physical mailing address, social security number, phone number, medical records, and bank account numbers or other financial data. Consumers feel most secure when the only PII you collect is information they provide to you directly, such as by filling out a form on your website.
- Non-PII is anonymous information that cannot be used to identify an individual. Non-PII is often used to track how visitors navigate your website, which pages were viewed most often, what other websites they have visited, and similar data.

You should also identify the technologies and methods your organization uses to collect PII and non-PII. Disclosing the methods used to collect this information can increase trust and confidence in your organization and help individuals decide whether to share their information with you.

(iv) How Collected Information Is Used

Your privacy policy should describe exactly how you will and will not use the information you collect. Use this as an opportunity to sell them on your website’s features and services. For instance, perhaps you use cookies to track what articles are read so that you can suggest related articles.

Because email spam is such a problem, the first question individuals usually have for an organization is “Will you give my e-mail address to anyone else?” Individuals are usually most comfortable when their email addresses are used only by the organization they directly give them to. However, there are many situations where organizations can benefit from sharing email addresses. Whether you plan to share information or not, it is vital that your privacy policy accurately describes your practices and, in the process, reassures individuals so they will continue to provide the information you need to successfully provide services you offer.

(v) How Consumers Can Opt Out

Generally speaking, it is a best practice that PII only be collected with the individual’s consent. If PII is collected without the consumer’s consent, your privacy policy should clearly explain how the consumer can opt out of your data collection process. The actual steps for opting out depend on the type of information you collect and the technologies you use to do it.

If you allow third-party advertising companies, such as 24/7 Real Media or DoubleClick, to run advertisements on your site, you should consider telling consumers

about these companies' information collection process and, if offered, how to opt out of such data collection. However, you do not have to provide the exact instructions; simply point individuals to the appropriate page on the third party's website. Alternatively, if the third-party advertiser is a member of the Network Advertising Initiative ("NAI"), point your customer to the NAI opt-out page at http://www.networkadvertising.org/optout_nonppii.asp.

(vi) How Collected Information Is Kept Secure

The security section of your privacy policy should describe how you ensure that all consumer information is protected from unauthorized disclosure and theft. If you share information with third parties, what steps do you take to ensure that they keep the information secure? Avoid describing the level of security in absolutes. There is no such thing as absolute assurance of security.

(vii) With Whom You Share Collected Information

It is not necessary that you list in your privacy policy every single company, organization, business partner, or entity that you might share collected information with. You should, however, mention types of entities you will share information with, such as other nonprofit organizations, business partners, credit card companies, and government agencies. For each type of entity, list the type of collected information you would share and under what circumstances.

e. CAN-SPAM for Nonprofits

No legitimate nonprofit organization wants to be known for sending spam out to potential donors. The federal law regulating spam is the Controlling the Assault of Non-Solicited Pornography and Marketing Act of 2003, 15 U.S.C. §§ 7701-7713 (2003) (the "CAN-SPAM" Act). The CAN-SPAM Act is a federal law regarding the sending of commercial email. And the law (and its steep penalties) potentially applies to activities of nonprofit organizations.

Under the CAN-SPAM Act, emails containing transactional or purely informational content are generally not covered. Examples of transactional content would include confirmation of registration or receipt of a donation, invoice and account information, and notice of expiration of services. Commercial emails that promote a product or service would trigger CAN-SPAM requirements.

There are certain actions that anyone engaged in sending commercial content in emails must do to comply with the rules of the CAN-SPAM Act:

(i) Use a Valid Header

Make sure the "from" line in the email accurately and clearly reflects the sender. Use appropriate email addresses such as "products@nonprofit.org," "programs@nonprofit.org" or "memberservices@nonprofit.org" to identify your organization. To donors and members, this also provides a comfort level because they know and trust the organizations they support.

(ii) Use a Valid Subject Line

There currently are no labeling requirements for the subject line (“ADV” for advertisement, for example). What is required is that the subject line not mislead recipients as to the content of the message. For example, if your email message is designed to solicit membership, the subject line should not be “I got your message,” “Hello from a friend” or other similar statements. Rather, use a subject line that is more truthful, such as “Invitation to join ABC Organization” or “Special offer for new members.”

(iii) Provide Clear and Conspicuous Notice of the Opportunity to Opt Out

Notice of the opportunity to opt out of future commercial emails must be in every email message containing a commercial solicitation offer and must be provided to all individuals receiving the message, whether or not they have opted in to receive commercial or solicitation email offers.

(iv) Provide a Functioning Opt-Out Mechanism in Every Commercial Email Message

A functioning opt-out mechanism can be a return email address or other Internet-based mechanism that is capable of receiving opt-out requests for at least 30 days after the transmission of the original message. The keys here are that the mechanism must be Internet-based and it must function. Also, the sender may not send subsequent offers more than ten business days after a recipient has requested to not receive further advertisements or offers. Further, if the recipient has opted out, the sender may not rent, exchange or otherwise transfer or release the email address of the recipient.

(v) Provide a Valid Physical Postal Address of the Sender

A valid physical postal address must be included in every email. A street address or post office box would be considered a valid physical postal address.

Solicitations via email are also considered to be covered under the rules established in the Charitable Solicitations Act (“CSA”). See Chapter 43 for more information about CSA rules.

PART XIII. CEASING OPERATIONS

Chapter 70. Considerations Before Ceasing Operations

A time may come when the directors or members of a nonprofit determine that it is no longer feasible or desirable to keep the corporation operating in its current state. In some instances, ceasing operations is not necessary; the directors may find less extreme approaches to correcting problems. For example, if the board of directors finds that a nonprofit corporation is no longer able to fulfill its mission, the board might consider broadening or narrowing the scope of the corporation's purpose and/or reducing or changing its activities. Likewise, if the directors are ready to step away from a nonprofit, it may be possible to elect a new board of directors with the energy and resources to manage the corporation. If these options are not realistic then the directors must decide the best approach to ceasing operations. The options include merger, consolidation, dissolution, or, in the event of financial difficulties, bankruptcy. This Part provides a general overview and discussion of each procedure and some considerations for the board of directors (or members if the organization has voting members) when faced with the decision to cease operations. The material will focus on mergers and dissolutions (both voluntary and involuntary) but will also highlight bankruptcy and involuntary liquidation.

The decision to cease operating is an important one. Like all aspects of their actions as directors, the steps to cease operating must be undertaken with a focus on the best interests of the corporation. Before undertaking a merger or dissolution the board and, if the corporation has voting members, members should ask themselves what is best for the corporation and the public it serves. Several of such questions, which will help a board or members decide which approach to take in ceasing operations, are included here.

- Do current members/directors wish to keep operating the nonprofit?
- Is there an organization that might be interested in acquiring the assets of the nonprofit?
- Is there an organization with a similar purpose available as a potential merger partner?
- Are there significant designated charitable assets or significant liabilities associated with the nonprofit?
- Is there dissension that might require court intervention?
- Is there an organization that might be interested in taking over the nonprofit?

The *ABCs of Nonprofits* (2005) by Lisa Runquist contains a helpful discussion regarding these considerations and others.

The directors may decide that greater efficiency in carrying out the corporation's objectives could be obtained by merging or consolidating with another corporation. The directors may decide that bankruptcy and liquidation is necessary to make arrangements with

creditors, or the directors may determine that the most sensible course is dissolution of the entity. A merger or consolidation may be appropriate where another corporation with a similar purpose exists. If the organization has substantial liabilities, however, merger may not be a good (or available) option and dissolution will be the preferred route. In each case, the Board must pay attention to applicable laws and to restrictions on gifts received by the nonprofit. Normally, the directors or members control the operations. There are, however, certain instances when the corporation will be subject to involuntary dissolution or liquidation.

Chapter 71. Merger or Consolidation of a Nonprofit Corporation

a. Generally

This Chapter focuses on the legal mechanics of a merger or consolidation of two or more nonprofit corporations. There is much more to the process, however, than the legal formalities. Identifying a suitable partner for a merger or consolidation, bringing together the cultures of the different organizations, and handling public relations are just a few of the many business issues involved in a merger or consolidation. Directors and, if applicable, members should consider the potential economic, organizational, and strategic benefits and detriments of merging or consolidating before any decision is made.

Washington law permits nonprofit corporations to merge with each other or to form a new corporation by consolidating with each other. The law also permits nonprofit corporations formed in this state to merge or consolidate with nonprofit corporations formed outside of Washington. Merger and consolidation are similar, but differ in one crucial way. In a merger, two or more corporations join together, with one of those corporations emerging at the end of the process as the surviving corporation. In other words, one of the corporations continues to exist, while the other is merged into it. In a consolidation, by contrast, two or more corporations join together to form a new corporation. Each of the consolidating corporations ceases to exist, creating a new corporate entity by the act of combining. In this case, a new application for tax-exempt status will need to be prepared and submitted to the IRS.

When two corporations merge or consolidate, the surviving entity (or the new entity in the case of a consolidation) will normally receive any bequests designated for the merged organization. For example, Nonprofit A and Nonprofit B merge with B surviving. Although A no longer exists, any bequests designated for A in wills or trusts would pass to B as A's successor in merger. If A were to simply dissolve and distribute its assets to B, any bequests designated for A would not pass to B. This succession is a reason to look favorably at merging instead of dissolution, but keep in mind that in our merger example, B also assumes all of A's debts and liabilities, even contingent ones. Where liabilities are a concern, merger or consolidation may not be as desirable an option.

b. Effecting a Merger or Consolidation

The officers of the merging or consolidating corporations may spend many hours negotiating and documenting the terms of the merger or consolidation. However, the merger or consolidation is not legally effected until certain steps have been taken and specific

documents filed with the Washington Secretary of State. Mergers and consolidations are governed by the Washington Nonprofit Corporations Act), which should be reviewed and followed at all stages of the process. In addition, the articles and bylaws of the organizations should be reviewed for additional requirements, such as approval of an affiliated organization.

(i) Plan of Merger or Consolidation

The process for performing a merger begins with each corporation adopting a plan of merger. That plan must identify:

- The names of the corporations planning to merge;
- The name of the corporation into which they will merge;
- The terms and conditions of the merger;
- A statement of any changes in the articles of the surviving corporation to be effected by the merger; and
- Such other provisions as are deemed necessary or desirable.

Corporations planning to consolidate begin similarly by adopting a plan of consolidation containing similar information.

(ii) Board of Directors or Membership Approval

The plan of merger or consolidation must then be approved by the boards of directors of each corporation and, if one or both of the corporations has voting members, by their respective corporate membership. For a corporation that has members with voting rights, the board of directors must present the plan to the members at an annual or special meeting. Approval of the plan requires the assent of at least two-thirds of the votes of members present or represented by proxy (if proxy voting is permitted) at a meeting in which a quorum exists. Any merging or consolidating corporations that do not have members with voting rights must approve the plan by vote of a majority of the directors then in office at a meeting of the board in which a quorum exists.

(iii) Articles of Merger or Consolidation

Upon approval of the plan of merger or consolidation by each of the corporations, articles of merger or articles of consolidation must be prepared, executed by an authorized officer and filed with the Secretary of State together with the appropriate filing fee. The articles of merger or consolidation must include the plan of merger or consolidation and a description of the process used by each corporation to approve the plan. If the Secretary of State determines that the articles of merger or consolidation conform to law and that all fees have been paid, the Secretary files the documents and issues a certificate of merger or certificate of consolidation. The merger or consolidation becomes effective upon the filing of the articles of merger or consolidation or at a later date as provided in the plan of merger or

consolidation, which later date must be within 30 days of the filing of the articles of merger or consolidation.

(iv) Foreign Corporations

The merger or consolidation procedure differs from the procedure described above if one or more of the corporations included in the merger or consolidation was not incorporated in Washington. Washington corporations involved in such a transaction are required to follow the procedures outlined above. Each “foreign” or non-Washington corporation must follow the law of the state in which it was incorporated. If the surviving corporation or new corporation will be a “foreign” corporation, then the corporation must (a) obtain a certificate of authority prior to transacting business in Washington, (b) file an agreement that it may be served with process in Washington, and (c) appoint the Secretary of State as its agent to accept service of process.

(v) Completion of the Merger or Consolidation

Once the merger or consolidation has been effected, the several corporations become a single corporation. The separate existence of the corporations that do not survive the transaction cease. The surviving corporation obtains all the rights and duties that the Act provides and is also responsible for all the liabilities and obligations of each of the corporations involved in the merger or consolidation. In the case of a merger, Washington law deems the articles of incorporation of the surviving corporation to be amended in the manner stated in the plan of merger, and in the case of a consolidation, the articles of incorporation of the new corporation are deemed to consist of the statements contained in the plan of consolidation and that are required or permitted by the Act to be set forth in articles of incorporation.

(vi) Merger and Consolidation Distinguished From an Asset Sale

As a final note, merger and consolidation should be distinguished from transactions in which a corporation simply sells or transfers its assets. The process of effecting a merger or consolidation involves changing the actual corporate entities involved. In contrast, if a nonprofit corporation continues to exist but sells or otherwise disposes of all or substantially all of its assets, other than through the ordinary course of business, a separate set of statutory rules apply. In such asset disposition transactions, approval is required by either the corporation’s members having voting rights or, if none, by a majority of the corporation’s directors then in office, in each case at a meeting in which a quorum is present.

Chapter 72. Dissolving a Nonprofit Corporation

Washington law provides several methods for dissolving a nonprofit corporation. A corporation can be dissolved voluntarily, by action of its own directors and members, administratively by the Washington Secretary of State for failure to comply with filing requirements of that office, or in very limited circumstances, by a superior court judicial decree.

a. Voluntary Dissolution

When the directors and members of a nonprofit believe it is in the best interests of the corporation to discontinue as a legal entity, certain actions may be taken in order to dissolve the nonprofit corporation. This process is referred to as voluntary dissolution and is summarized below.

(i) Resolution to Dissolve

The first step in a voluntary dissolution is the adoption of a resolution by the board of directors supporting corporate dissolution. If the corporation has members with voting rights, then the voting members must also adopt a resolution to dissolve at either an annual or special meeting. Each member with voting rights must be provided with notice of that meeting between 10 and 50 days in advance, either personally or by mail, facsimile or electronic mail, subject to the requirements of the Act. The resolution of dissolution must be approved by a two-thirds vote of the members present or represented by proxy (if proxy voting is permitted) at a meeting in which a quorum is present. If the corporation has no members with voting rights, then a resolution adopted by a majority of the directors in office suffices to dissolve the corporation.

(ii) Notice of Adoption of a Resolution to Dissolve

Once the dissolution resolution has been adopted, the corporation must cease to conduct its affairs except as necessary to wind up. In addition, the Act requires a notice of the proposed dissolution be provided to each known creditor of the corporation, to the attorney general with regard to any assets held for a charitable purpose, and to the Washington State Department of Revenue. This notice should contain the plan of distribution described below. The notice to the Department of Revenue must request a clearance certificate which certifies that the corporation does not owe any taxes to the state.

(iii) Plan of Distribution

Once a resolution to dissolve has been approved, a plan, called the plan of distribution, that details how the corporation's assets will be distributed must be prepared. Like the resolution to dissolve, the plan must be approved by the members having voting rights, if any, or if there are no such members then by a majority vote of the directors in office, in each case at a meeting in which a quorum is present.

The Act outlines the order of distribution of a nonprofit corporation's assets upon dissolution. The plan of distribution must comply with these statutory requirements. First, the corporation must apply its assets toward satisfying all of its liabilities and obligations prior to distributing assets elsewhere. The corporation's liabilities and obligations include all corporate debts, including, presumably, payroll, withholding and state taxes. Withholding is particularly important to pay in a timely manner because of the ability of the IRS to seek payment from directors personally.

Second, if the corporation holds any assets subject to a condition requiring their return or transfer upon dissolution, then any such assets must be returned or transferred in accordance with that condition.

Third, if the corporation holds any assets subject to limitations designating their use only for charitable purposes, then those assets must be disposed of as required by the donor's instructions or transferred to another corporation, society or organization exempt from federal taxation under § 501(e)(3) of the Code engaged in activities similar to those of the dissolving corporation. Before transferring any assets that fall into this category, the corporation must notify the Office of the Attorney General by registered or certified mail, at its Olympia office, of the proposed disposition of such assets. The notice must be mailed at least 20 days before the meeting at which the corporation plans to adopt the plan of distribution. The corporation may not adopt a plan regarding such assets without the approval of either the attorney general or of a court of competent jurisdiction in an action to which the attorney general is a party. However, if the attorney general fails to object within 20 days of the corporation's mailing of the plan of distribution to its office, then state law deems the Office of the Attorney General to have given its approval.

Fourth, the corporation may distribute any of its remaining assets in accordance with its articles of incorporation or bylaws, to the extent that those documents provide for the distribution of assets. If the corporation's articles of incorporation or bylaws do not specify how assets should be distributed, then these remaining assets are distributed according to the terms of the plan of distribution. The plan of distribution must also meet the requirements of federal tax law.

(iv) Articles of Dissolution and Certificate of Dissolution

The final step of voluntary dissolution is filing articles of dissolution with the Secretary of State. Until articles of dissolution are filed, the nonprofit can revoke the dissolution process as explained in the next section. The corporation must distribute its assets in accordance with the plan of distribution prior to filing the articles of dissolution. The articles of dissolution must be signed by one of the corporation's officers and must set forth the following statutorily required information:

- Identification of the corporation by its legal name;
- The date of the meeting of the corporation's members adopting the dissolution resolution and a statement that the members adopted the resolution by a two-thirds vote at a duly called meeting at which a quorum was present or unanimously consented to dissolution in writing. If the corporation has no members with voting rights, the articles of dissolution must so state, and provide the date of the meeting at which the board of directors approved the dissolution;
- A statement that all of the corporation's debts, obligations and liabilities have been paid or provided for otherwise. In connection with this statement, the corporation must obtain a clearance certificate from the Department of Revenue demonstrating that the corporation does not owe any taxes to the state and must attach a copy of this certificate to the articles of dissolution;

- A statement that the corporation's assets have been appropriately distributed; and
- A statement that either there are no lawsuits pending against the corporation or that adequate provision has been made for satisfaction of any judgment resulting from a pending suit.

If the Secretary of State finds that the articles of dissolution conform to law, the Secretary will accept the articles for filing and issue a certificate of dissolution. At that point, the corporation is dissolved.

(v) Revocation of Voluntary Dissolution

The corporation may revoke its dissolution at any time prior to the issuance of a certificate of dissolution by the Secretary of State. Like the decision to dissolve, the decision to revoke dissolution is made by resolution and must be approved by the corporation. Revocation of the dissolution resolution requires the approval of the corporation's members if members have voting rights, or a majority vote of the corporation's board of directors in office. Any vote by the members requires the support of two-thirds of the members present or represented by proxy (if proxy voting is permitted) at a duly called meeting at which a quorum is present. Upon the adoption of a resolution revoking the earlier dissolution resolution, the corporation may again conduct its affairs normally.

b. Involuntary Dissolution

The Act provides that a nonprofit corporation may also be dissolved involuntarily, either by administrative action of the Secretary of State or judicially by the superior court.

(i) Administrative Dissolution

The privilege of operating as a nonprofit corporation carries with it certain operating requirements, including filing requirements with the Secretary of State. Nonprofit corporations that fail to strictly adhere to these requirements or that cease operation without filing articles of dissolution risk being dissolved by administrative action. Administrative dissolution may occur even where the board of directors or members do not wish to cease operations of the corporation.

Washington law requires the Secretary of State to administratively dissolve any corporation that:

- Has failed to file or complete its annual report within the time required by law;
- Has failed for 30 days to appoint or maintain a registered agent in Washington; or
- Has failed for 30 days, after change of its registered agent or registered office, to file in the office of the Secretary of State's Office a statement of such change.

If any of these conditions occur, the Secretary of State mails written notice to the corporation to provide it with an opportunity to correct the problem and avoid dissolution. If the corporation fails to correct the problem, the Secretary of State dissolves the corporation. A corporation that has been administratively dissolved may apply to the Secretary of State for reinstatement as an active corporation by bringing all of its filings up to date and by paying any back fees and a reinstatement fee.

The possibility of administrative dissolution should provide nonprofit corporations with substantial incentive to comply with the legal requirements of maintaining a corporation. Small and relatively informally operated nonprofit corporations often fail to comply with corporate filing requirements, sometimes with serious consequences. While the Secretary of State must notify a corporation prior to an administrative dissolution and give the corporation an opportunity to cure the problem, the Secretary of State is only required to send this notice to the corporation's registered office. Consequently, if the corporation has not maintained an accurate, current filing with the Secretary of State as to its registered office, then the corporation may not receive the notice. Nonetheless, the administrative dissolution will be valid.

The loss of corporate status may jeopardize the organization's federal tax-exempt status because that status is dependent upon the existence of the corporation. In addition, the corporation may find that, during its dissolution period, another entity took its name. Corporate names must be distinguishable from those of other entities on file with the Secretary of State. If, during an administrative dissolution period, another corporation reserves or adopts the same or similar name, then the dissolved corporation may be required to change its name as a condition of reinstatement.

A corporation's opportunity to reinstate as a matter of right is limited to the first three years after the date of dissolution. If more than three years have elapsed, then the corporation can seek reinstatement only through a special application process. This late reinstatement option, however, requires a statement under oath by a responsible corporate officer describing the reasons why the corporation failed to make its legally required filings. The Secretary of State can reinstate the corporation only if each of following conditions exists:

- There are sufficient exigent or mitigating circumstances;
- The corporation has acted in good faith;
- The failure to reinstate would cause disproportionate harm to the corporation;
and
- Reinstatement would not be contrary to the public interest.

(ii) Judicial Dissolution

Under rare circumstances, the superior court can dissolve a nonprofit corporation by decree. In an action commenced by the attorney general, the superior court has the authority to dissolve the corporation if the corporation has either procured its articles of incorporation through fraud or has continued to exceed or abuse the authority conferred upon it by law.

There are no reported cases in Washington's appellate courts of any proceeding under this statute. This lack may be explained by the fact that the statutory threshold is rather high and that judicial dissolution may be sought only if the statutory conditions are met.

c. Effect of Dissolution

Once a nonprofit corporation has been dissolved, its claim to exist as an entity distinct from its members, officers or directors continues only to the extent provided by state law. In the case of a voluntarily dissolved corporation, state law provides that upon adoption of a resolution of dissolution by the members or board of directors, as applicable, the corporation must cease to conduct its affairs, except in so far as may be necessary to "wind up" the corporation's affairs.

The administrative dissolution of a corporation by the Secretary State causes the existence of the corporation to immediately cease, subject only to the corporation's right of reinstatement. The board of directors of the administratively dissolved corporation, however, continues to hold title to the corporation's property as trustees for the benefit of the corporation's creditors and members, if any. This provision prevents a gap in ownership of the corporation's assets given the likelihood that, because a corporation's dissolution was involuntary, no distribution plan for the corporation's assets existed at the time of dissolution.

State law preserves any rights or remedies that a third party may have against a corporation, if properly pursued by any such party within two years after dissolution. In other words, when a corporation dissolves, it may still be sued by any party to whom the corporation owes money, or is otherwise liable due to some event that occurred prior to dissolution, within two years following dissolution. The corporation or its members, board of directors and officers retain the authority to, and are advised to, defend such actions.

Corporate dissolution may also create an issue as to whether individuals who incur liability while acting on behalf of a dissolved corporation are entitled to the protection of the corporate form. One of the principal benefits of incorporation is the limitation on individual liability that follows from it. Individuals who continue to act on behalf of the dissolved corporation, with or without knowledge of the dissolution, may be personally liable for their actions. While Washington courts have not addressed this issue in the context of a nonprofit corporation, the Washington Supreme Court has addressed this issue regarding a for-profit corporation. In that case, the Washington Supreme Court concluded that the individual acting on behalf of the dissolved corporation was not personally liable for his actions. Nevertheless, the possibility of personal liability should present individuals with a powerful incentive to avoid administrative dissolution.

Chapter 73. Bankruptcy

A thorough discussion of the bankruptcy process is beyond the scope of this Handbook. Instead, this Chapter highlights some of the issues specific to nonprofits in the bankruptcy process. A nonprofit considering bankruptcy will almost certainly need to seek legal assistance before filing a bankruptcy petition. It can be a complicated procedure, and once a petition has been filed, there are restrictions placed on a debtor. For example, payment

of attorneys' fees and nonroutine business transactions all require the consent of the court after a Chapter 11 petition is filed. Moreover, at least one commentator has warned that an entity in reorganization may no longer be tax-exempt when it comes out of the process. Evelyn Brody, *The Charity in Bankruptcy and Ghosts of Donors Past, Present, and Future*, 29 Seton Hall Legis. J. 471 (2005). Finally, if the goal of the directors is reorganization under the bankruptcy code, the board should consider how a bankruptcy filing will impact donors. Will they rally in support or will they give their money elsewhere?

Although for-profit corporations can be made the subject of involuntary bankruptcy proceedings, creditors of nonprofit corporations cannot force these into involuntary proceedings. However, a nonprofit may file for voluntary bankruptcy under either Chapter 7 or Chapter 11 of the bankruptcy code. Chapter 7 is titled Liquidation. As the name implies, the assets of the debtor are gathered and distributed to pay creditors. In a Chapter 7 proceeding, the organization is controlled by an independent bankruptcy trustee who will generally not be knowledgeable of the organization's business and will do nothing but sell off the assets and make distributions to creditors. Chapter 11 is titled Reorganization. Chapter 11 is a mechanism by which a financially distressed organization may be able to emerge financially viable once more. Under Chapter 11, the debtor normally becomes a debtor in possession and can continue operating in its normal course of business under its existing management. A debtor in possession is also allowed to develop its plan of reorganization, the plan describing how creditors are to be paid. However, Chapter 11 is a difficult, time-consuming, and expensive process and there are very few examples of Chapter 11 reorganizations of nonprofits.

Once a petition is filed, an automatic stay is imposed. The stay prevents creditors from taking any actions to enforce pre-petition liens. The stay does not apply to regulatory enforcement by a governmental unit. Actions that have been allowed to continue despite a bankruptcy petition have included the revocation of a nonprofit's charter and revocation of tax-exempt status. *In the matter of Jesus Loves You, Inc.*, 40 B.R. 42 (Bankr. M.D. Fla. 1984); *Universal Life Church, Inc. v. United States*, 128 F.3d 1294 (9th Cir 1997).

Once a petition is filed, a bankruptcy estate is created consisting of all of the debtor's property and interests in property. The Bankruptcy Abuse Prevention and Consumer Protection Act ("BAPCPA") amended the bankruptcy code to require that the distribution of property from federally tax-exempt organizations comply with nonbankruptcy law. One issue, then, for nonprofits in the bankruptcy context is the identification of the bankruptcy estate. For example, the treatment of restricted gifts, endowments, pledges and other forms of gifts and donations carrying limitations on their use may not be clear. The restrictions may prevent the funds from becoming part of the bankruptcy estate. If restricted gifts and other assets survive the bankruptcy, the courts can use the doctrine of *cy pres* to distribute the gifts in a way that carries out the intent of the donor. Under the *cy pres* doctrine, assets are used for another charitable purpose that most closely lines up with the donor's intent when the original purpose becomes impossible, impracticable, or illegal.

Directors and officers should follow the restrictions placed on gifts to the corporation. Ignoring restrictions was costly to the Allegheny Health, Education and Research Foundation. The directors and officers of that foundation paid \$94 million to settle claims

brought by the attorney general. Other risks include exposing otherwise restricted gifts to creditor claims. (Brody, *supra* at 487-88; Robert White, *Charities in Distress: Selected Issues*, ABI-CLE (July 13-16, 2006).

BAPCPA also amended the bankruptcy code to allow a greater role for the state and attorney general in bankruptcy proceedings where charitable assets are at stake. Daniel J. Callaghan, *An Overview of the Role of the Attorney General in Bankruptcy Proceedings Involving Charitable Organizations*, ABI-CLE 207 (July 13-16, 2006). Several provisions of BAPCPA are applicable to the bankruptcy of health care facilities (both profit and nonprofit) including special procedures to protect patient privacy and an exception to the automatic stay for the Secretary of Health and Human Services. Nonprofit health care facilities should take special care to ensure that they are complying with the new bankruptcy requirements.

Chapter 74. Judicial Liquidation

Washington law permits courts to liquidate the assets of a nonprofit corporation under certain circumstances. The judicial liquidation statute allows either a member or director of the corporation, or the attorney general, to bring an action to liquidate the assets of a corporation where one of the following conditions exist: (a) management deadlock that is causing or threatening to cause irreparable injury to the corporation, (b) illegal, oppressive, or fraudulent actions by those in control of the corporation, (c) misapplication or waste of the corporate assets, or (d) an inability by the corporation to carry out its purposes. As with judicial dissolution, however, this procedure exists as a safeguard against unusual situations, not as a general method of oversight of corporate internal affairs.

An action for judicial liquidation is to be brought in the county in which the registered agent or principal office of the corporation is situated. Directors or members are not necessary parties to such suit unless relief is sought against them.

Creditors have the right to bring an action under the statute when either (1) the creditor's claim has been reduced to judgment and an execution thereon has been returned and it is established that the corporation is insolvent or (2) the corporation has admitted in writing that the claim of the creditor is due and owing and it is established that the corporation is insolvent.

A court may also liquidate a corporation if the corporation applies to have its liquidation continued under the supervision of the court or when the attorney general has filed to dissolve a corporation and it is established that liquidation of its affairs should precede the entry of a decree of dissolution.

In a proceeding to liquidate, the court has the authority to issue injunctions, appoint a receiver, and take other actions necessary to preserve the assets of the corporation. The statute requires that the assets of the nonprofit or the proceeds resulting from the sale, conveyance, or other disposition be applied and distributed in a specific order.

Chapter 75. Endowment Funds

Endowment funds require special consideration when ceasing operations. These funds are restricted as to their use by the nonprofit. Typically, endowment funds are designated so that the recipient charity may use the income from the fund while preserving the principal. Special steps must be followed to release the endowment fund restrictions before the funds can be distributed. Washington is one of many states that have adopted the Uniform Management of Institutional Funds Act (Chapter 436, Laws of 2009, to be codified as a new Chapter in Title 24 RCW. The Washington statute defines an institution as “an incorporated or unincorporated organization organized and operated exclusively for educational, religious, charitable, or other eleemosynary purposes or a governmental organization to the extent that it holds funds exclusively for any of these purposes.” An endowment fund is “an institution fund, or any part thereof, which is not wholly expendable by the institution on a current basis under the terms of the applicable gift instrument.” In order to release the restrictions imposed on the endowment funds, the nonprofit may ask the donor to consent to the release or, if obtaining the donor’s consent is impractical, the nonprofit may petition the superior court for a release. Even if a release of the restrictions imposed on the fund is obtained, the endowment fund may not be used for purposes other than educational, religious, charitable, or other eleemosynary purposes.

Directors and members should also pay particular attention to other restricted gifts. Some restrictions designate a successor charity in the event the primary beneficiary ceases to exist or fails to use the funds as required. Failure to follow the conditions imposed on restricted gifts may result in unexpected consequences for the directors, including exposing the funds to creditors’ claims and personal liability for directors. Brody, *supra* at 487-88; White, *Charities in Distress: Selected Issues*, ABI-CLE (July 13-16, 2006). Section 6 of Chapter 436, Laws of 2009, provides conditions under which restrictions on endowment funds can be released. or modified.

Appendix A to Washington Nonprofit Handbook

Biographies of Handbook Authors and Lead Editors

Judith Andrews

Judith Andrews practices in the areas of nonprofit corporation law, tax-exempt organizations, and public finance. She represents many non-profit organizations on corporate and tax exemption issues including determination of tax-exempt status, legal obligations of directors, organization structure, and roles of board and staff, conversion, merger and affiliation issues, and federal tax-exemption issues. In addition, she has worked on many special fund revenue bond and non-recourse revenue bond financings, many of which have involved 501 (c)(3) organizations. Judy currently chairs the WSBA Business Section's Nonprofit Corporations Committee and was appointed to serve on the Secretary of State's Charities Advisory Council. She is an adjunct professor at Seattle University School of Law, as well as in the Master of Public Administration program. Judy is a graduate of the University of Notre Dame Law School.

Ms. Andrews authored Part II of this handbook (How to Form a Nonprofit) as well as Chapters 10, 15, 17 and 19 of Part III (Governance and Operations). Judy also served a lead editor.

Putnam Barber

Putnam Barber is the Senior Researcher for Idealist.org and editor of its Nonprofit Frequently Asked Questions (FAQ) at <http://www.nonprofits.org>. In addition, he is a Senior Advisor at the Nancy Bell Evans Center on Nonprofits & Philanthropy. He chairs the Charities Advisory Council of the State of Washington for the Office of the Secretary of State. Until recently, Mr. Barber was also Senior Consultant to Executive Alliance, the association of nonprofit leaders from the central Puget Sound region. He is a graduate of Haverford College and earned an MA in population studies at the University of Pennsylvania.

Mr. Barber wrote Part I (Introduction) and Chapters 44 (Nonprofit Bulk Mailing Permits), Chapter 46 (Fundraising Involving Gambling) and Chapter 47 (Alcoholic Beverages at Fundraising Events). Putnam also served as a lead editor of this handbook.

Lance Behnke

Lance Behnke is an attorney at K&L Gates. His practice focuses on a variety of federal and state tax issues relevant to both domestic and foreign business clients. His experience includes mergers and acquisitions, divestitures and sell—offs, and inbound and outbound investments. Mr. Behnke also advises client regarding tax issues associated with energy and real estate investment trusts. A significant portion of his practice addresses Washington state tax matters.

Mr. Behnke also provides tax and corporate advice to a number of nonprofit organizations, including philanthropic institutions organized as private foundations or public charities. His work in this area includes organizing nonprofit corporations and trusts, securing federal tax exemptions, preparing Internal Revenue Service ruling requests, and drafting and negotiating grant agreements.

Mr. Behnke authored Part VI (International Activities and Grantmaking).

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Cory Sbarbaro is founder and principal of Turnpoint Consulting, an independent firm that strives to deepen the impact of progressive nonprofit organizations in the Pacific Northwest. His areas of expertise include executive transitions and interim leadership, organizational assessment, planning and strategy formation, executive coaching, and board development. In addition to his work as a consultant, Mr. Sbarbaro is a Senior Advisor at the Nancy Bell Evans Center on Nonprofits & Philanthropy, a trainer for United Way of King County and the Nonprofit Center of South Puget Sound, and an instructor for the Nonprofit Management Certificate Program at the University of Washington. He was co-creator of the Pacific Northwest Nonprofit Executive Leadership Institute, and currently serves as lead instructor for the program. Mr. Sbarbaro holds an MPA from the Evans School of Public Affairs. He has served on several nonprofit boards, most recently as the Board President of Solid Ground. Mr. Sbarbaro can be reached at cory@turnpointconsulting.com.

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Robert A. Seale is an attorney in the Seattle office of K&L Gates LLP. His practice focuses on a wide variety of federal tax matters, with a special emphasis on tax-exempt organizations. Mr. Seale received his B.S. from Southern Methodist University (2000), his J.D. from the University of Montana School of Law (2005), and his LL.M. (in Taxation) from New York University School of Law (2006).

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Carol Sureau

Carol Sureau received her Bachelor's degree from UC Berkeley in 1982 and her Juris Doctor from UC Berkeley Boalt Hall in 1986. Ms. Sureau's practice in San Francisco focused on litigation, with an emphasis on insurance issues. She relocated to Washington State and since 2000 has been the Deputy Commissioner of Legal Affairs for the Washington State Insurance Commissioner's Office.

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Linda Walton is a member of the Perkins Coie LLP Labor and Employment Law National Practice Group and a member of the firm's Strategic Diversity Committee. In her practice, Ms. Walton defends both private sector and public sector employers in state and federal employment-related litigation matters. Ms. Walton also devotes a significant part of her practice to providing preventative counseling to employers in a variety of contexts, including day-to-day advice on a wide range of employment law compliance matters, and the design and presentation of employment law training programs for managers, supervisors and human resources personnel on a variety of topics, including among others, workplace harassment, wage and hour law compliance, FMLA compliance, and Title VII compliance.

A frequent lecturer on the subject of employment law, Ms. Walton served for a number of years as an adjunct professor teaching Employment Discrimination Law at the Seattle University School of Law, and she has served on the faculty of both the National Institute for Trial Advocacy (NITA), Northwest Regional Program, and the NITA Northwest Regional Deposition Program.

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Tamara L. Watts is an attorney in the Seattle office of K&L Gates. Her practice focuses on federal and state law that impacts tax-exempt organizations. She assists a number of tax-exempt organizations with corporate matters and federal and state tax matters, including organizing nonprofit corporations, securing and maintaining federal tax exemptions, private foundation excise taxes, international philanthropy, excess benefit transactions and conversions and restructurings.

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LaVerne Woods

LaVerne Woods chairs Davis Wright Tremaine's Tax-Exempt Organizations group. Ms. Woods is a past Chair of the American Bar Association Section of Taxation Exempt Organizations Committee and of the Washington State Bar Association's Business Section Nonprofit Corporations Committee and co-convener of the Legal Work Group advising the Independent Sector's Panel on the Nonprofit Sector. She has taught in the University of Washington School of Law's Graduate Program in Taxation and is listed in The Best Lawyers in America and in Washington Law & Politics' "Super Lawyers." Ms. Woods represents nonprofit organizations in matters such as qualification for tax exemption, mergers and restructuring, joint ventures and entrepreneurial activities, intermediate sanctions, creation of "friends of" and supporting organizations, unrelated business income tax, Internet-based activities, conversions to and from tax-exempt status, advocacy, charitable solicitations, endowment management, and tax-exempt bond financing. She helps private foundations establish grantmaking compliance programs and provides grantmaking training workshops. She also advises both donors and charities on charitable giving.

Ms. Woods co-authored Part V of this handbook (Maintaining Federal Tax-Exempt Status for Your 501(c)(3) Organization) with Jeanette Lodwig.

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