ILLINOIS **CPA** SOCIETY™
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GETTING ORGANIZED

A GUIDE FOR NEW NONPROFIT ORGANIZATIONS

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ILLINOIS CPA SOCIETY

GETTING ORGANIZED
A GUIDE FOR
NEW NONPROFIT ORGANIZATIONS
(Excluding state and local governmental units)

PURPOSE

This guide is intended to be used as an initial reference for newly-established nonprofit organizations as well as a resource for members of the Illinois CPA Society. It is not intended to be an all-inclusive guide, but should be used as a reminder of some of the business considerations when a nonprofit organization commences operation.

CONTENTS

I. THE MISSION STATEMENT: A GUIDE FOR TODAY AND TOMORROW

Ask yourself some very basic questions about your organization. Why was it formed? Whom will it benefit? What are you trying to accomplish in the community? Define your purposes in the broadest sense. Set these thoughts down in writing in a Mission Statement. Some reasons a nonprofit is created may be for educational, charitable, religious, literary or scientific purposes.

A clear declaration of the mission of an organization is a most useful tool in the decision-making process used by those who govern the organization. These include the Board of Directors as well as the administrative staff.

Review your mission statement frequently. Filter every policy decision through its wording. Revise the mission statement as needed, but only under the authority and approval of the Board of Directors.

The mission of a dynamic organization can and will change over time. For instance, the March of Dimes crusaded on behalf of a cure for polio during the 1950's and 1960's. When the disease was brought under control through the use of vaccines, the mission was broadened to include a fight against birth defects. This was a conscious decision of management and subsequent decision making was based upon efforts in this new area. The mission had changed and management had adjusted. Note that if substantive changes are made there may be notification requirements to both the Internal Revenue Service and the Illinois Secretary of State under the Illinois Not-for-Profit Incorporation Act. The same can be said for substantive changes to the organization's constitution and by-laws.

GOALS AND OBJECTIVES:

Once you have defined the mission of your organization, you should plan for those goals and objectives which will help achieve its mission. These should include both short-term and long-term goals as well as specific steps that the organization will take to meet these goals.

Write down what you hope to accomplish and itemize a list of specific objectives.

In addition, you may wish to consider the following matters:

- Determine a name for the organization which briefly captures its nature and its purpose. If you incorporate, this name must be approved by the Secretary of State. Whether you incorporate or not, register the name with the county recorder.

- Determine the geographic area you wish to serve and a strategic location for your headquarters.

- Determine your fiscal year. If possible, it should coincide with that of your prime funding source.

- Decide upon the structure of the organization. Draw an organization chart (including reporting relationships) and outline job functions, the size of the staff and job qualifications. Your analysis should include the basic functions of program services, administrative services and fund- raising. Other functions which are specific to your organization should also be identified.

- When do you want to start operations? Establish a target date.

- What kind of equipment do you need? Make a list. Get price quotes.

- What kind of space will you require (size, location, office layout)?

- Contact a CPA who has experience with nonprofit organizations. A CPA can assist in many areas: setup of your organization, establishing a report filing calendar; selection of accounting systems; as well as ongoing consultation and support.

- Start to develop a funding plan. Do your purposes and objectives fit with government funding requirements? What foundation might be interested in your program? The Donor's Forum in Chicago may be helpful in locating funding sources. Appendix D lists this source as well as other sources of information.

- Establish contact with a banker. In addition to providing a mechanism for cash movement within your organization by use of checking and savings accounts, a banker can provide valuable information on investment advice, credit availability and other matters.

- Ensure that there are no governmental or business restrictions which would limit your activities or require licensing to commence operations.

II BOARD DEVELOPMENT

The judicious selection of your Board of Directors will assist you in the success of your organization and the accomplishment of your objectives. Your board members must first be dedicated to the mission of the organization. Other desirable traits include:

- prominence within the community at large and in the focus area of your nonprofit
- strong planning skills
- ability and willingness to assist actively in fundraising activities both in connecting you to resources and in providing resources
- financial acumen
- diversity of opinion
- problem solving skills
- willingness to ask the "tough questions" in a nonthreatening manner
- ability to assist in identifying other candidates for board positions

The type of people you might look for include:

- Business and labor leaders
- elected officials
- executive directors and senior management of other nonprofit organizations
- community leaders and activists
- consider representation by the constituency being served by the nonprofit

You want your board to be active and directly involved in the organization, particularly in the areas of fundraising, public relations, policy making and technical assistance. You should assess the skills and capabilities that you need for your board and solicit individuals who can fill gaps in your needs.

There should be a clear delineation of board member and staff responsibilities so that there is no confusion as to their various roles.

Members of your board should expect a high level of commitment from you to the goals of the organization. In addition, board members should be able to expect and receive a high degree of transparency in your operations including financial performance. Other things that board members should expect include:

- organizational orientation
- annual schedule of meetings
- timely receipt of minutes of meetings
- regular financial reports
- regular updates on progress toward achieving goals
- commitment to an objective evaluation process for staff and board member performance

III. BUDGETING AND PLANNING

Your specific objectives and general plans have already been established. You must now go through the necessary process of building a detailed budget. A proposed budget is required in the document you file with the Internal Revenue Service to obtain your tax exempt status and is useful as an integral part of fundraising proposals and business planning. The budget can then be used to measure your progress throughout the year by comparing actual figures to budgeted amounts.

Seek help from your Certified Public Accountant when preparing your budget. To assist you in locating a qualified CPA, talk to other nonprofit organizations, your attorney or banker or contact your state CPA society or the American Institute of CPAs.

Additional information about support and revenue classifications can be found in Appendix A. Various expense classifications are listed in Appendix B.

Before assembling your budget you should begin to design the framework of your personnel system:

- write a job description and determine a salary range for each staff position (minimum and maximum).

- determine personnel policies: vacation, sick leave, holidays, personal absence, salary review timing and percent increase ranges.

- determine policy for reimbursement to employees for business use of personal automobile (rate per mile, tolls, parking) or public transportation. If the federal government is a funding source, consider using the federal "per diem" rates for reimbursement of travel expense.

You are now ready to begin to "build" the budget for your first year of operations. You should consider each of the following types of expenses to estimate the cost of your first full year of operations:

- SALARIES: Outline each staff position, including starting date, starting salary, salary review date, anticipated salary increases and make an estimate of the total salaries in the first year.

- FRINGE BENEFITS:

  FICA (Social Security and Medicare): beginning January 1984, nonprofit employees must be covered under the social security system. Determine your costs by multiplying total taxable salaries by the current tax rate, remembering to take into consideration the Society Security wage base limit.

  UNEMPLOYMENT TAX: Nonprofit organizations exempt under section 501(c)(3) of the Internal Revenue Code are exempt from federal unemployment tax. In Illinois, 501(c)(3) organizations can elect the tax or reimburse the State for the benefits paid to any of their workers. Other classes of nonprofits do not receive this option. Consult with your CPA as well as the Department of Employment Security.

  WORKERS COMPENSATION INSURANCE: Any organization with employees must obtain coverage for on-the-job injuries to its employees. Contact your insurance agent.

  GROUP INSURANCE: (Health, Life & Retirement) Costs of such plans can vary widely based upon factors such as the type of coverage provided, coinsurance provisions, deductibles and the percentage of cost paid in by employees. In addition, a packaged plan will generally be less expensive than a plan which is custom-designed for your operation.

  Evaluate many options before selecting a Group Plan. Packages are available through various nonprofit trade groups as well as other sources. Consultation with your insurance agent will help you make your selection.

- PAYROLL TAXES:

  FICA, State Unemployment Taxes and Federal Unemployment Taxes, if applicable, are paid by the employer. As such, you will be required to know the rates in effect for your organization as well as various filing deadlines for the taxes.

  SUGGESTION: Much of the administrative work involved in payroll preparation and payroll tax filing can be avoided with the use of an outside payroll service. These services are economical and can provide cost savings over in-house preparation in most instances. Consult your CPA.

- PROFESSIONAL FEES AND SERVICE CONTRACTS:

  You will probably need help in setting up your operations. This may come in the general areas of program services, accounting and auditing, and legal services.

  Some of these costs will be one-time-only and some will be ongoing. For budgeting purposes, you will want to know the nature, extent, and amount of these costs needed to set up your systems as well as the amount of outside professional service fees required to maintain those systems.

- DUES AND SUBSCRIPTIONS:

  Membership dues to trade and professional organizations as well as subscriptions to industry periodicals are appropriate to the management of your organization and should be considered when planning your budget.

- SPECIFIC ASSISTANCE TO STAFF: (i.e. medical assistance, educational assistance and training expense)

  These costs may or may not be relevant to your nonprofit organization. Careful planning and recordkeeping are essential in their implementation. Consult your CPA or attorney.

- PROFESSIONAL FUNDRAISING FEES:

  If it will be necessary for you to use outside fundraisers in your organization, their fees should be considered and anticipated in the budget.

- DEPRECIATION:

  Assets which decline in value over time are subject to periodic charges to expense based upon their projected life spans. Your CPA will show you the options available in this regard.

- SUPPLIES:

  You will need supplies to run your programs as well as your office. Review services offered by various vendors in this area.

- TELEPHONE:

  Choose the type of telephone services which are most consistent with the needs of your organization.

- POSTAGE AND SHIPPING:

  Postage costs can play a minor or relatively major role in your budget depending upon your intended usage. Special postal rates are available to nonprofit organizations from the United States Postal Service. Discounts for presorted mailings, return reply envelopes, zip code presorts as well as other discounts are available. Contact the USPS for details.

  If you intend to ship a number of larger packages, you may also want to inquire about the services offered by shippers such as United Parcel Service. If time is a priority, overnight shippers such as Federal Express offer their services at relatively moderate rates.

  Depending upon your needs, you may consider options to mailing such as electronic mail or FAX machines.

- OCCUPANCY:

  Rent, utilities, maintenance and repairs as well as other services should be anticipated in your budget.

- INSURANCE:

  Insurance should be considered for your organization in AT LEAST the following areas: Owned and leased property; liability for your general operations; operation of owned and leased autos; liability related to program services; liability related to actions of the Board of Directors; insurance against work related injuries; and employee dishonesty.

  Consult your insurance representatives about insurance services they may provide as well as inspection and loss control services.

- PRINTING:

  Brochures, pamphlets and other duplicating may be a part of your budget. Consult with various vendors.

- EQUIPMENT RENTAL AND MAINTENANCE:

  You may be confronted with lease or buy decisions depending upon the types of equipment your operation requires. Consult your CPA.

  Unfortunately, most equipment requires periodic servicing. For the purpose of making repair costs more predictable, service contracts should be considered for beyond-warranty protection of equipment used in operation of the business.

- CONFERENCES, CONVENTIONS AND MEETING EXPENSES:

These costs will vary based upon the nature of the organization.

- <u>MISCELLANEOUS</u>:

  Many expenses do not logically fit into the above named groups. Some may be irregular in occurrence and some may be unanticipated. As your accounting system matures, you should hope to find that fewer expenses arise that are unanticipated.

Make an estimate of the amount of all other types of expenses you anticipate. Once you have totaled your anticipated expenses you will know your funding requirements.

Revenue should be budgeted in the same detailed fashion, taking into consideration each revenue stream of the organization.

If you are anticipating any revenue or expense items that are unrelated to your tax-exempt purpose, you should be careful to identify and account for these items separately.

Revenue and expense from fundraising events will also need to be identified and accounted for separately.

IV. INCORPORATING AND OTHER START-UP FORMALITIES

Your purposes and objectives will normally determine whether you wish to be organized as a club, association, trust, nonprofit corporation of other type of entity. The Internal Revenue Service Publication 557, "Tax-Exempt Status for Your Organization" will be helpful in explaining the process for filing for tax exempt status either under IRS Form 1023 or Form 1024. Another helpful publication is "A Guide for Organizing Not-for-Profit Corporations" published by the Illinois Secretary of State.

Seek the services of an attorney, preferably one with experience with nonprofit organizations. If you need help with the selection of an attorney, ask the American Bar Association, your local bar association, your CPA or banker. Because of the financial information required on some applications, including identification of certain activities of your organization that could be taxable (i.e. unrelated business income), you should also seek the help of a CPA familiar with nonprofit organizations.

If your decision is to incorporate, your attorney and/or CPA can assist with the following steps:

- Establishing the bylaws which describe the organization's objectives and assign authority and responsibility to the board and staff.

- Filing articles of incorporation with the Secretary of State (SOS) as a nonprofit corporation, Form NP-102-10. Decide who will be the organization's Registered Agent will be for completion of these forms. The Registered Agent will receive all legal notices from the SOS. Be sure the wording is such to ensure compliance with IRS requirements for tax exemption.

- Obtaining a federal employer identification number (form SS4).

- Registering with the State as an income tax withholding agent (in Illinois, form701).

- Filing for real estate tax exempt status, if applicable.

- Registering with the state unemployment office (in Illinois, form UC-1).

- Registering with the Office of the Illinois Attorney General Charitable Trust Division under the Charitable Trust Act (760 ILCS 55/1) and the Solicitation for Charity Act (225 ILCS 460/1), if applicable. Form CO-1.

- Register for sales tax exemption with IL. Department of Revenue – refer to their publication 104.

V. ACCOUNTING REQUIREMENTS

Proper accounting information is essential in planning, organizing and controlling any organization. It provides information that is critical to a nonprofit organization's ability to effectively evaluate its performance, financial strength and ability to carry-out its mission.

Due to the complexities that are inherent in adhering to financial reporting requirements, maintaining compliance with laws and regulations, and establishing a sound internal control framework, it is recommended that professional assistance be obtained in the event that relevant expertise is not possessed by existing employees of the organization. A certified public accountant (preferably with experience with nonprofit organizations) can evaluate your situation and advise you as to the extent and nature of assistance necessary to put your organization on sound footing in these areas. There are a variety of solutions available depending on an organization's circumstances to ensure the accounting function is adequately controlled, including full-time or part-time accountant(s)/bookkeeper(s) or outsourced accounting services. In addition, smaller nonprofit organizations might consider combining back-office services, including accounting, to achieve economies of scale in staffing administrative functions.

Regardless of an organization's unique circumstances, there are some common aspects related to the implementation and operation of the accounting function. These include the following:

- Processing Transactions – The basic function at the core of any organization's accounting department is the processing of the financial transactions necessary for the organization's operations. There are numerous transaction cycles that could potentially exist at a nonprofit organization depending on the nature of their programs and revenue streams. The most common transaction cycles that will be encountered, particularly at developing nonprofit organizations, include the following:
    - Cash Receipts
    - Cash Disbursements
    - Payroll

- Internal Control System - Development/Maintenance – Internal controls can be defined as the processes and procedures implemented by an organization that are designed to safeguard assets, ensure the reliability and accuracy of financial reporting and facilitate compliance with laws and regulations. The development of sound internal controls is critical to an organization's overall financial success
- Financial Reporting – The accounting function is typically responsible for taking an organization's financial data and converting it into reports that can be evaluated by a nonprofit organization's stakeholders. Financial statements of a nonprofit organization that are prepared in accordance with generally accepted accounting principles (GAAP) are required to include the following financial statements:
    - Statement of Financial Position – reports an organization's assets, liabilities and net assets (the equivalent of equity in for-profit accounting)
    - Statement of Activities – reports an organization's revenues, expenses, gains, losses, and changes in net assets
    - Statement of Cash Flows –reports an organization's cash used and provided by operating, investing and financing activities

  However, nonprofit organizations will also work with the data that is housed in the organization's accounting systems to produce other financial reports that help in the decision making process.

  Financial Reporting Systems – There are numerous solutions for a nonprofit organization to process, track and report their financial activities. However, the majority of organizations do use some type of accounting software package to carry out this function. The approach to managing this function is driven by an organization's operations and complexity. The expertise of a certified public accountant will aid effective decision making in identifying and implementing the right solution for an organization.

Accounting and Financial Reporting Resources for Nonprofit Organizations

- *FASB Accounting Standards Codification* ™
- AICPA Audit and Accounting Guide – *Not-For-Profit Entities*
- AICPA Not-for-Profit Entities: Accounting Issues and Risks
- AICPA Not-for-Profit Entities Industry Developments

Internal Control Resources

- Committee of Sponsoring Organizations (COSO) - http://www.coso.org/

<u>VI. AUDITING REQUIREMENTS</u>

There are a variety of circumstances that can trigger the requirement for a nonprofit organization to obtain an audit of their financial statements by an independent public accountant. The most common factor that would result in a nonprofit organization being required to obtain an audit report would be state regulatory requirements. State regulations vary as to financial reports and audits required from nonprofit organizations. In Illinois, charitable organizations that have revenue of $300,000 or more are generally required to file annual financial statements audited by an independent CPA.

Additionally, nonprofit organizations that expend $500,000 or more in federal awards annually must have a compliance audit conducted in accordance with Government Auditing Standards and OMB Circular A-133.

Whether or not statutory requirements dictate that an audit be conducted, new nonprofit organizations should consider engaging a CPA firm to examine and report on their financial statements. In the current environment, it is common for donors and grantors to request and/or expect that nonprofits receiving their funding have a financial statement audit conducted.

VII. TAX AND REPORTING REQUIREMENTS

Various federal and state agencies have been established to review and regulate organizations operating within their jurisdictions. Ask your attorney and CPA to determine whether your organization must comply with the following reporting requirements. They can also assist you in the timely completion of filing of such reports.

Form 990 series returns are required to be filed by most tax-exempt organizations except for church and government-affiliated organizations. Those returns under the Form 990 series include the "full" Form 990, Form 990 EZ, Form 990-N and Form 990-PF for private foundations. Forms 990 are due by the fifteenth day of the fifth month following the end of the fiscal year but are permitted to be extended. Effective in tax year 2008, the "full" Form 990 was substantially updated to provide for increased disclosures of operational activities, compensation, conflicts of interest and governance practices. The Form 990 is the IRS primary tool for gathering information about tax-exempt organizations, for educating organizations about tax law requirements and ensuring their compliance. Organizations use it to inform the public about their programs. The filing of Forms 990, 990-EZ and 990-N are based upon gross receipts and total asset thresholds. A tax-exempt organization can file a Form 990-EZ rather than Form 990 if its annual gross receipts for tax year 2009 are less than $500,000 ($200,000 for tax years 2010 and later) and if its total assets at the end of tax year 2009 are less than $1,250,000 ($500,000 for tax years 2010 and later). Small tax-exempt organization whose annual gross receipts are normally $25,000 or less ($50,000 for tax years ending on or after December 31, 2010) may be required to electronically submit Form 990-N, also know as the e-Postcard, unless they choose to file a complete Form 990 or Form 990-EZ.

Tax-exempt organizations can be subject to income tax on certain of its trade or business activities if those activities result in income that is not substantially related to its exempt purpose. Unrelated Business Income (UBI) commonly results from advertising as well as passive investment income and rents generated from assets acquired by incurring debt. UBI is taxed at the same rates as corporations. Since this tax is based on net unrelated business income, the computation of UBI requires that all appropriate expenses be applied to offset any gross unrelated amounts. The determination of what expenses are appropriate to offset gross UBI is a matter of judgment and may require the use of expense allocations. An organization will be required to file form 990-T and any applicable state income tax returns to report any unrelated business income. The UBI is reported on Forms 990T and any applicable state income tax returns.

Tax exempt organizations are also subject to federal and state employment taxes. As a new employer, the first place to go for information is Publication 15, Employer's Tax Guide (Circular E). This publication, revised annually, contains basic information employers need to collect information needed to determine and pay their and employees' employment tax liability, file correct tax returns, and withhold federal taxes. The following table from the Exempt Employer's Toolkit of the IRS website summarizes typical federal employment tax reporting requirements of tax exempt organizations.

Form	Discussion
W-2, *Wage and Tax Statement* (instructions included)	This form must be issued to recipients of wages, and copies filed with the IRS.
W-3, *Transmittal of Wage and Tax Statements* (with instructions)	This form is used to transmit Forms W-2 to the IRS.
W-4, *Employee's Withholding Allowance Certificate*	This form must be furnished to each employee upon hiring, to determine correct withholding. An employee may submit a new certificate at any time.
W-9, *Request for Taxpayer Identification Number and Certification* (with instructions)	This form is furnished to a person who receives a payment from an organization, to verify the recipient's taxpayer identification number.
941, *Employer's Quarterly Federal Tax Return* (with instructions)	This form must be filed each quarter by an employer, including an exempt organization, who pays wages during the quarter.
944, *Employer's Annual Federal Tax Return* (with instructions)	This form may be filed by certain employers with small payrolls who have been notified by the IRS that they can file on an annual basis, instead of filing Form 941 quarterly.
945, *Annual Income Tax Withholding Return* (with instructions)	This form must be filed to report withholding on payments other than wages. Examples of such payments are pensions, annuities, and individual retirement accounts.
1099-MISC, *Miscellaneous Income* (with instructions)	Must be filed by a payer who makes certain payments for services to recipients who are not employees.
1096, *Annual Summary and Transmittal of U.S. Information Returns*	Used to transmit Forms 1099-MISC to the IRS.
I-9, *Employment Eligibility Verification*	Required for all newly-hired employees. This form can be obtained from U.S. Citizenship and Immigration Services.

For the employment obligations for the state of Illinois, please refer to Publication 130, Who is required to withhold Illinois income tax.

Unlike other 501(c)(3) public charities, private nonoperating foundations are subject to a 1% or 2% excise tax on their net investment income each year and also have requirements to distribute a minimal amount of their qualifying assets each year.

Most states also require charitable tax exempt organizations to register and submit certain financial reports. Those requirements often result from an organization doing business or soliciting funds in a particular state. The state of Illinois requires organizations to register through Form CO-1, Charitable Organization Registration Statement. Once registered, the organization is required to file Form AG990 on an annual basis. Audited financial statements are further required if gross contributions exceeded $300,000 or if the organizations used a paid professional fundraiser which raised contributions in excess of $25,000. Contributions include the gross sums paid by the public for merchandise, rights or services of the organization, as well as cash donations. Please review the "Building Better Charities" section of the Illinois Attorney General's website for specific filing requirements. Tax exempt organizations that receive Federal government support often require additional reporting requirements. Those requirements include certifications and other informational reports to be filed with the responsible Federal agency on a regular basis. For Federally sourced support in excess of $500,000, an organization may be required to obtain an independent audit in accordance with Government Auditing Standards as well as the provisions of OMB Circular A-133 (commonly called the Single Audit Act). Sometimes it is difficult to distinguish between Federally sourced funding and funding provided by state or local sources.

VIII. UBIT CONSIDERATIONS

Just because an organization has received a favorable determination as an exempt organization does not mean that the organization is entirely exempted from the payment of income taxes.

Tax exempt organizations pay income tax on what is called Unrelated Business Income (UBI). UBI is income that results from a trade or business that is regularly carried on and is not substantially related to the purpose for which the organization has been granted exempt status.

For purposes of UBI, the IRS defines a trade or business as including "any activity carried on for the production of income from selling goods or providing services". The term "regularly carried on" refers to how often an organization is engaged in an activity and whether the activity is carried on in much the same manner as nonexempt organization would carry on the activity.

The fact that the income is ultimately used to carry on the exempt functions of the organization does not free it from the requirement of paying tax. Exempt organizations with more than $1,000 in UBI must file IRS Form 990-T "Exempt Organization Business Income Tax Return" on or before the 15th day of the fifth month after the organization's year end (e.g. May 15th for an organization that has a December 31st year- end).

While there are many types of income that result in UBI, the most common types are: income from advertising in magazines or newsletters, sponsorship income for which the sponsor receives more than mere recognition, and the sale of membership/ donor lists to businesses.

For more information on unrelated business income see IRS Publication 598 titled Tax on Unrelated Business Income of Exempt Organizations. You can find it at The Internal Revenue Service's website: irs.gov. Consulting a tax adviser experienced in the taxation of exempt organizations can help you to legally reduce potential taxation.

IX. BANKING

Most nonprofits need to receive money and pay bills, which entails opening a bank account. Banking is highly regulated and you may find opening an account to be difficult. Don't be discouraged if you have to make more than one trip to the bank to retrieve missing documentation.

Start by shopping around for a bank or credit union that offers low or no monthly maintenance fees to nonprofits. Ask other nonprofit leaders where they have accounts, ask your personal banker, and look on the Internet.

Identify the type of accounts that will be needed. Most common is a checking account. If there will be excess funds, it's good to invest in a money market account or Certificates of Deposits (CDs). Compare rates and be sure accounts are FDIC insured or NCUA insured for credit unions.

Identify the positions within the nonprofit that will have authority over the account(s). It's useful to have 2 or even 3 people. Common positions are the executive director, treasurer, president, or a past treasurer.

When you are ready to go to the bank to open the account, ask for a list of items you should bring. These may include:

- Federal Employer Tax ID Number (an FEIN functions as a social security number for the non-profit)

- A copy of the Nonprofit corporation filing with the State of Illinois (or other state)

- Articles of Incorporation with State of Illinois (or other state.) If the group is not incorporated, the bank may need other support documentation such as a letter of direction from the non-profit's officers.

- Corporate resolution or copy of approved minutes authorizing establishment of the account(s) and identifying the officer positions that have signing authority over the account(s).

- A Certificate of Incumbency of Officers, which is a document confirming the names and titles of officers in the nonprofit.

It may help for the nonprofit's president, as its highest ranking officer to be go with you and the other signers to the bank to open the account. At the bank, each signer will need to provide their social security number and 2-pieces of personal identification, which may include driver’s license, passport, state ID, major credit card, or other acceptable form of identification.

Special Bank Needs

Some nonprofits have special requirements such a need to receive large numbers of checks, online credit card donations, or processing lunch orders and payment to name just a few. New solutions are developing all the time to solve fundraising challenges. To illustrate a few of the options, the following are offered. This is not an endorsement of any solution. Information about the companies listed below can be found via an Internet search.

To process a large number of checks consider a lock box at a commercial bank.

Most commercial banks will provide information and costs.

To process credit cards onsite and online, larger nonprofits can obtain a merchant credit card processing account which is cost effective for higher transaction volumes due to significant monthly fees. Smaller nonprofits, with less consistent monthly volumes, may consider PayPal or an online application such as Acceptiva to accept online donations. Nonprofits that manage their own website may find Google Checkout to be a good option.

Nonprofits that run school lunch program may find myFoodDays.com useful. This online application allows PTO's, PTA's and HSA's to put their lunch orders online so that parents can pre-order in an efficient way.

Appendix A

Support and Revenue Classifications

Support and revenue classifications will vary depending on the type of organization. An important consideration is to segregate your organization's receipts by the nature of their sources, or the conditions under which they were received (e.g., restricted or unrestricted). The following list is an example of support and revenue classifications your organization may require:

Support:

Federated fundraising agencies and similar fundraising organizations
Membership dues and assessments from the general public
Fundraising Events
Related organizations
Grants or similar payments from local, state or federal government services
Cash and noncash contributions
Donated property and services

Revenue:

Membership dues and assessments
Annual Conference Fees
Publications
Educational seminars
Investment Income including dividends, interest and other similar amounts)
Royalties
Rental of Real and Personal Property
Gain or loss on Sales of Securities or Other Assets
Program Service Revenue
Miscellaneous Revenue

Appendix B

Expense Classifications

The first step in classifying expenses is an understanding of what expenses are. FASB Concept No 6, Elements of Financial Statements, defines expenses as "outflows or other using up of assets or incurrences of liabilities (or a combination of both) from delivering or producing goods, rendering services, or carrying out other activities that constitute the entity's ongoing major or central operations" as opposed to losses which stem from peripheral activities.

For financial reporting purposes, an organization needs to report expenses by their functional classifications, such as major classes of program services and supporting activities, in either the statement of activities or the notes to the financial statements. Generally, functional expenses include activities involving program, management and general, fundraising, and, if applicable, membership development.

However, most organizations budget along natural classifications such as salary, payroll taxes, printing, etc. (See the list below for more detail.) Such budgets are often broken out into more detail, showing program or department. These natural classifications, while useful in several respects, differ from the functional classifications needed for reporting purposes.

Finally, most organizations are required to file an informational return with the IRS (Form 990) which asks for expenses to be presented both by natural classification (row) and by functional classification (columns).

It is important that the organization set up its chart of accounts so that expenses can be allocated for all of these reporting needs.

Functional expense classifications accumulate expenses according to the purposes for which costs are incurred. One of these purposes is Program, which refers to those expenses incurred in the operation of the organization's exempt purpose. While this is the category that funders frequently feel is most important, other types of expenses are equally important as they represent the expenses that maintain the infrastructure of the organization. The first of these categories is Management and General, that is, expenses that are not allocable to any particular program and yet are necessary to run the organization. Examples might be accounting, printing that isn't program specific, and non-program depreciation. And, finally, there are Fundraising expenses. These are the expenses incurred by the organization to raise the funds necessary to provide the programs they offer. Special event expenses, while part of Fundraising, are treated slightly differently than others for IRS informational return purposes, and need to be tracked by direct versus indirect expenses.

One way of grouping the natural classifications for reporting purposes includes following the IRS 990 Part IX, Statement of Functional Expenses:

Grants (be sure to separate US from foreign)
Benefits paid to or for members
Compensation of officers (separate these from the rest of the staff for everything except payroll taxes)
Other salaries and wages

- Pension plan contributions
- Other employee benefits
- Payroll taxes
- Fees for services (non-employees) (also called professional fees)
  - Management
  - Legal
  - Accounting
  - Lobbying
  - Professional Fundraising
  - Investment Management
  - Other
- Advertising and promotion
- Office expenses
- Information technology
- Royalties
- Occupancy
- Travel (if applicable, separate payments of travel or entertainment paid to public officials from other such expenses)
- Conferences, conventions, and meetings
- Interest
- Payments to affiliates
- Depreciation, depletion, and amortization
- Insurance
- Other

Under each of these categories, an organization may choose to break its expenses into more detailed categories for management purposes.

To add functional classifications to natural classifications, one should add a ‘class’ or account code section which allows invoices to be coded to different functional cost centers which use the same natural account number. For example, a printing invoice can be used for both Program and Fundraising. By coding the invoice to ‘printing’ and then splitting it appropriately to the different functional classes, the organization can capture all of its expense reporting needs at the time of input, when the information is still fresh and easy to obtain.

Appendix C

Names and Addresses of Regulatory Organizations (for Illinois Corporations)

Federal

Internal Revenue Service 230 S. Dearborn, 21st Floor Chicago, IL 60604 1-800-829-3676 312-566-4912 www.irs.gov	Obtain Federal Forms
Internal Revenue Service Attn: EIN Operation Cincinnati, OH 45999	File form SS-4
ERISA Filing Acceptance System (EFAST2)	File form 5500 Series
Department of the Treasury Internal Revenue Service Ogden, Utah 84201-0005	File form 941
Department of the Treasury Internal Revenue Service Center Ogden, Utah 84201-0027	File form 990
Internal Revenue Service (P.O. Box 192 – form 1023) (P.O. Box 12192 – form 1024) Covington, KY 41012-0192	File forms 1023 and 1024
Social Security Administration Data Operations Center Wilkes-Barre, PA 18769-0001 www.ssa.gov	File Annual form W-3 along with copies of W-2s

State of Illinois

Illinois Department of Revenue James R. Thompson Center, Concourse Level 100 West Randolph Street Chicago, IL 60601-3274 1-800-732-8866 www.revenue.state.il.us	Obtain State of Illinois forms
Illinois Department of Revenue Willard Ice Building 101 W. Jefferson Street Springfield, IL 62702 1-800-732-8866 217-782-3336	Obtain State of Illinois forms

www.revenue.state.il.us

Illinois Department of Revenue P.O. Box 19447 Springfield, IL 62794-9447	File forms IL 501, IL 941
Illinois Department of Revenue Willard Ice Building Sales Tax Division 101 West Jefferson Street Springfield, IL 62708 1-800-732-8866	Obtain sales tax exemption letter
Office of the Attorney General Charitable Trust Bureau Attn: Annual Report Section 100 West Randolph Street, 11th Floor Chicago, IL 60601-3175 1-800-964-3013 (312) 814-2595 www.illinoisattorneygeneral.gov	Annual Report to Attorney General
Secretary of State Dept. of Business Services – Corp. Div. 501 S. 2nd Street, Suite 350 Springfield, IL 62756 1-800-252-8980 217-782-6961	File Bylaws and Articles of Incorporation & Form NP63
State of Illinois Department of Employment Security 33 South State Street Chicago, Illinois 60603-2802 1-800-244-5631 (312) 793-5700 www.ides.state.il.us	
Illinois Department of Employment Security P.O. Box 19300 Springfield, IL 62794-9300 Employer Services Hotline: 1-800-247-4984/ 312-793-4880	File form UI-3/40

Appendix D

Sources of Information

American Institute of Certified Public Accountants
1211 Avenue of the Americas
New York, New York 10036
Phone: 212-596-6200
Fax: 212-596-6213
www.aicpa.org

Audit Guides and Alerts

BoardSource
1828 L Street, NW, Suite 900
Washington, DC 20036
Phone: (202) 452-6262 or 877-89BOARD (877) 892-6273 | Fax (202) 452-6299
Boardsource.org

Governance Assistance

Charity Navigator
139 Harristown Road Suite 201
Glen Rock, New Jersey 07452
201.818.1288
201.818.4694 fax
www.charitynavigator.org

Evaluation of Charities

The Association Forum of Chicagoland
10 S. Riverside Plaza, Suite 800
Chicago, IL 60606
Main number: (312) 924-7000
Fax: (312) 924-7100
info@associationforum.org

Various Publications

INDEPENDENT SECTOR
1602 L Street, NW, Suite 900
Washington, DC 20036
202-467-6100 phone
202-467-6101 fax
info@independentsector.org

Governance Assistance

CPAs for the Public Interest
550 West Jackson, Suite 900
Chicago, Illinois 60661
(312) 993-00407
1-800-993-0407

Various Publicatons

Donor’s Forum (312) 578-0090
208 South LaSalle, Suite 1540
Chicago, Illinois 60604
www.donorsforum.org

Possible Funding Sources

Illinois State Chamber of Commerce (312) 983-7100
300 S. Wacker Drive, Suite 1600
Chicago, Illinois 60606
www.ilchamber.org

Ready Reference on Unemployment Security

United Way of Metropolitan Chicago, Inc. (312) 906-2350
560 W. Lake Street (312) 876-0199 - Fax
Chicago, Illinois 60661
www.uw-mc.org

Illinois CPA Society (312) 993-00407
550 West Jackson, Suite 900 1-800-993-0407
Chicago, Illinois 60661
www.icpas.org

WEB RESOURCES

Internal Revenue Service Center, www.irs.gov

IRS's Lifestyle of an Exempt Organization: http://www.irs.gov/charities/article/0,,id=169727,00.html

Illinois Secretary of State:
http://www.cyberdriveillinois.com/departments/business_services/home.html

Illinois Attorney General Office, http://www.illinoisattorneygeneral.gov/charities/index.html

Illinois Department of Revenue, http://www.revenue.state.il.us/nonprofits/index.htm

AICPA Audit Committee Toolkit for not-for-profit organizations:
http://www.cpa2biz.com/AST/Main/CPA2BIZ_Primary/FinancialManagement/Management/AuditCommittee/PRDOVR~PC-991004/PC-991004.jsp

Illinois CPA Society, www.icpas.org

Illinois Legal Aid,
http://www.illinoislegalaid.org/index.cfm?fuseaction=home.dsp_content&contentID=4133

The Center for Effective Non-profits, U of I Extension, http://www.thecen.org/

Society for Nonprofit Organizations, http://www.snpo.org/resources/startup.php

Grant opportunities with Grants.gov, http://www07.grants.gov/index.jsp

Catalog for Federal Domestic Programs, https://www.cfda.gov/

Philanthropy News Digest, http://foundationcenter.org/pnd/npodesign/npodesign_arch.jhtml

The National Council of Nonprofits, http://www.councilofnonprofits.org

United We Serve, www.serve.gov

Volunteer Match, www.volunteermatch.org

Appendix E

Done ✓	When to File	Form Description	See Page
□	Begin Your Journey	Application for Recognition of Exemption Internal Revenue Service Forms 1023 OR Form 1024	
□	Step 1	Application for Reservation of Name under General Non Profit Organization Corporation Act, Form NFP 104.10 ✓NFC 104.10 reserves your corporate name for 90 days ✓File with the Secretary of State's office ✓$25.00 filing fee	18
□	Step 2	Articles of Incorporation, Illinois Form NFP-102.10 ✓Form 102.10 incorporates you as a nonprofit organization ✓File with the Secretary of State's office ✓$50.00 filing fee	24
□	File with 102.10	Addendum to Illinois Form NFP 102.10 ✓Addendum contains clauses required by IRS for federal tax exemption. ✓File along with Form 102.10	26
□	Step 3, within 15 days of receiving Certificate of Incorpor.	Notification to county Recorder of Deeds office ✓File Articles of Incorporation and Certificate of Incorporation with county Recorder of Deeds office Filing fee and time limit set by each county office.	38
□	If needed	Local Business Registration ✓Register to obtain Business License if needed ✓Applications available – local City Hall	41
□	Step 4	Application for Employer Identification Number (FEIN), Form SS-4 ✓A FEIN number identifies your nonprofit on government documents ✓Filing is free and can be done over the phone	41
□	Close of Quarter		44

□	File within 30 Days after Close of Quarter	Employer’s Quarterly State Tax Return, Form IL-941	72
□	Date of Incorp. Anniversary	Annual Report to Illinois Secretary of State ✓Filing Fee $5.00	86
□	File by the 15th day of 5th Month after Fiscal year end	Form 990 Return Form 990T UBIT Return, if applicable	94
□	File within 6 Months of year end	Charitable Organization Supplement, AG990-IL ✓Filing Fee $15.00	96
□	File within 6 Months of year end	Form 1FC Report of Individual Fundraising Campaign	98

Appendix F

Fundraising Rules and Regulations

FILING REQUIREMENTS

Illinois Attorney General's Office

1. Registration (Form CO-1/2/3)
2. Annual Report (Form AG990-IL) – due six months after year-end (with up to two additional extensions of time)
3. Report of Individual Fundraising Campaign (attached to AG990-IL, if applicable)

Internal Revenue Service - Form 990

Form 990 (or Form 990-EZ) is a required annual IRS filing for tax-exempt organizations having annual gross receipts of $25,000 or more ($50,000 in 2010 and later).

Form 990 is available for public inspection and organizations must make a copy available upon request. In general, anyone may request a copy of any of the three most recently-filed Forms 990. Generally, written requests must be honored within 30 days of receiving the request, while in-person requests for copies must be honored the same day. Organizations may charge a reasonable fee for postage and copying.

The public nature of the Form 990 is discussed here for two reasons. First, the increased availability of Form 990 may result in more requests for your organization's Form 990 from potential donors. Second, fundraising activities are among those transactions highlighted in various sections on Form 990.

Form 990 has recently been significantly revised and now includes expanded disclosure requirements regarding governance policies and practices, including: conflict of interest, whistleblower protection, document retention and destruction, compensation determination and review, joint ventures, documentation of minutes, affiliate policies, Form 990 review, grantmaking, gift acceptance, and expense and travel reimbursement. Organizations should review their policies and procedures and consult with their legal and accounting professionals for compliance with the questions on the revised Form 990.

SPECIAL FUNDRAISING EVENTS AND SOLICITING ON-LINE

What is a Special Event?

By purchasing a ticket to an event such as a gala, banquet, show, golf outing, or athletic event, a supporter of the organization not only makes a financial contribution to the organization but also receives the right to attend the event. Because special events involve a benefit flowing to the donor, the presumption arises that the donor's payment to attend the event is not a gift, unless the total payment exceeds the value of the benefit received, and the donor paid such excess with the intention of making a gift. Accordingly, the donor/attendee is eligible for a charitable contribution deduction for federal income tax purposes only to the extent that the amount paid to attend the event exceeds the value of the benefits received. The contributions are known as *quid pro quo* contributions, or contributions made partially in consideration for goods or services provided by the charity.

Internal Revenue Code section 6115 requires that the organization holding the event provide a contemporaneous written disclosure, with respect to *quid pro quo* contributions greater than $75 per person, indicating that only amounts contributed in excess of the fair market value of benefits provided will be tax deductible. The organization is also required to provide a “good faith estimate” of the value of benefits provided. Typically, a disclosure is made on the face of the ticket(s) or in a letter accompanying the tickets or thank-you letter.

Penalties for noncompliance with section 6115 are $10 per *quid pro quo* contribution for which the required disclosure was not made, up to a maximum of $5,000 per fundraising event or mailing. Note that section 6115 applies not only to special events, but to any instance in which a donor makes a payment greater than $75 and receives benefits that do not fall within one of the following safe harbors:

- Intangible religious benefits;
- Annual membership benefits normally offered to patrons for annual payment of $75 or less, where such benefits consist of privileges which may be exercised frequently (e.g., free admission, free parking) during the year; or
- Fair market value of benefits received does not exceed the lesser of 2% or the payment, or $86, whichever is less;(valued at less than 2% of the contribution, or $86, whichever is less); or
- Payments of at least $43.00 and the only items provided are token logo items valued at less than $8.60 (low-cost items). *Note these figures are adjusted by the IRS annually for inflation.*

It is also important to note that if a fundraising activity is considered to be regularly carried on, and does not in some manner further the organization’s exempt purposes except through the production of income, it may be characterized by the IRS as a trade or business whose net profits are subject to unrelated business income tax (“UBIT”). Annual or semi-annual fundraisers are not likely to raise UBIT concerns, but events conducted on a weekly or monthly basis may. Consult your tax advisor for a detailed analysis of you organization’s activity.

Calculating the Direct Benefit to Event Attendees

The first step in calculating the value of benefits provided to attendees of a special event is to arrive at a “good faith estimate” of the goods and/or services provided, usually by reference to the value of similar or comparable goods or services. Another way of reviewing this is to determine the price a seller would have received if he/she had sold the goods or services in the usual market in which he/she customarily sells, regardless of whether such goods or services are being donated to the organization for the event. For example, if a caterer is donating the cost of feeding a group of 200 people at a special event luncheon to your organization, consult the caterer to determine what they would normally charge, per plate, for the foodservice rendered. In another example, in a charity performance of a symphony, the fair market value of attending the performance might be the normal ticket price charged for a seat in the symphony hall (including differences for balcony seat prices versus ground floor seats).

The second step is to aggregate the value of all benefits received by each attendee, and compare it to the total ticket price. If, for example, the value of the benefits received by a ticket holder is $45, and the ticket price is $100, then the written disclosure under section 6115 should provide this information, as well as a statement that the amount eligible for a charitable contribution deduction is $55.

Note that the aggregate <u>cost</u> of an event, divided by the number of attendees, is not necessarily equal to the <u>fair market value</u> of the benefits received by attending the event. Aggregating the costs associated with producing an event may be indicative of the value, but further research may be

needed to arrive at a good faith estimate. Unfortunately, the IRS does not provide detailed guidance concerning how to calculate a fair market value; no formulas are given in published guidance.

However, based on the Treasury Regulations (see Reg. Sec. 170A-1(h)(5) Example 3) it would appear that the IRS is primarily concerned that the "good faith estimate" be within the <u>range</u> of typical retail prices for the goods or services provided. An example in the Regulations cites an organization that receives a payment of $200 from a donor, and provides a book in return. The book is typically available at the retail at prices ranging from $18 to $25. The organization provides the donor with a written disclosure statement that the donor has received a book value at $20, and his net charitable contribution is $180. Since the $20 value given is within the range of available prices for the book, the $20 estimate is not in error, and the donor may treat the $20 estimate as the fair market value of the book in calculating his charitable contribution on his personal tax return.

If a ticket holder does not attend the event, he/she is not entitled to deduct the full ticket price as a charitable contribution deduction simply because he/she did not actually receive the benefits of attending. His/her charitable contribution remains the excess of the price paid for the ticket over the fair market value of the benefits he/she would have received (and had the right to receive) had he/she attended. By contrast, if the ticket purchaser "donates" or returns his/her ticket to the organization so that it may be resold, the ticket purchaser has made a charitable contribution equal to the full amount of the ticket price.

Raffles

Many organizations conduct raffles in conjunction with, or during, a special event. Purchases of raffle tickets are considered purchases of a chance to win a prize; therefore, the amount paid to purchase raffle tickets is not deductible in whole or in part as a charitable contribution. The chance to win a prize is viewed as full consideration for the price of the ticket.

You are required to file a Form W-2G for each person to whom you pay $600 or more, *if such amount is at least 300 times the amount of the ticket*. If the prize is less than $600 or less than 300 times the amount of the ticket, it does not need to be reported. For example if the ticket is $10 and the prize is $2,500, no W-2G needs to be filed for the winner. In addition, if the ticket price is $1 and the prize is $500, no W-2G is required by the Service.

Federal income tax is required to be withheld at a rate of 28% from the amount of winnings less the amount of the ticket if the winnings less the amount of ticket exceed $5,000 *and the winnings are reportable* as set forth above. If by chance the recipient of reportable winnings does not provide a Taxpayer ID Number (Social Security Number) you must backup withhold at the rate of 28% on any such winnings that are not subject to regular withholding. This would apply if the winnings were at least $600, at least 300 times the ticket price and not more than $5,000. Income tax withheld on these winnings must be reported annually on Form 945 and deposited with the Internal Revenue Service separately from your payroll tax deposits.

For raffles held in the Chicago City limits, a license must be filed with the city 30 days before the tickets are sold. For more information regarding raffle in Chicago and the application, contact the City of Chicago, Department of Revenue, Business License Division at (312) 744-3947. For more information regarding license or permission required by other municipalities, please contact the municipality in which your organization intends to hold the raffle.

Sweepstakes

Sweepstakes differ from raffles in that a purchase is not necessary for the individual to be entered in the prize drawing. There is no dollar amount spent by the individual; therefore there is no charitable contribution or purchase associated with entering the drawing. In contrast with raffles, the value of any prize winnings in excess of $600 should be reported to the winner of the drawings on Form 1099-MISC.

Silent Auctions

Silent auctions follow the quid pro quo rules outlined above; that is, the item purchaser will not have a charitable contribution deduction unless the amount paid for the auctioned item is greater than its fair market value, and the purchaser's intent was to make a gift of the excess amount spent to an exempt organization. Under the rules of section 6115, it is the organization's responsibility to disclose in writing a "good faith estimate" of the fair market value of each item available in an auction. This information may appear, for example, in an auction "catalog" of items available for purchase, with a statement that the proceeds of the auction will go to the organization.

Gambling, Bingo, and Casino Nights

1. Information reporting requirements for prize winnings are the same as for raffles, above.
2. If regularly carried on, gambling activities may result in UBIT. However, an exception to UBI treatment exists under Code section 513(f) for bingo games.
3. The IRS has devoted substantial discussion in its CPE Texts for Exempt Organization agents to the issues surrounding the use of "professional" casino operators. Organizations utilizing the services of these operators should pay careful attention to the supervision of the operator and its employees, to avoid private inurement and/or private benefit. (See IRS Publication 3079).
4. Event attendees should be made aware that the dollars they spend on gambling activities are not eligible for a charitable contribution deduction. Likewise, volunteers who act as "dealers" cannot claim a deduction for the value of their donated services.

MISCELLANEOUS ISSUES

City of Chicago's General Guidelines for Special Events and Licensing

The Mayor's Office of Special Events oversees all outdoor special events hosted by not-for-profit (and for-profit) organizations. They have produced a Special Events Resource Guide that outlines the guidelines and procedures to be followed for such events, including:

- Requests for City services,
- Street closure requests,
- Recycling plans,
- Noise Control plans,
- Notification to local Police District and local Alderman's offices,
- Temporary Food Vendor License, and
- Itinerant Merchant License (if goods are to be sold at the event)

General Information:

A. An organization (i.e. church, non-for-profit, for-profit) is required to obtain Special Events licenses to conduct any outdoor festival, street fair or carnival located on the public way or on private property.

B. Each organization must submit a Special Event Permit Application 45 days prior to the event. Additional Special Event Permit Applications must be submitted for multiple events.

C. All applications must be completed in its entirety. Any changes to the application after it has been submitted begins a new 45 day timeline.

D. A Certificate of Insurance for $1,000,000 Commercial General Liability, naming the City of Chicago as an Additional Insured, must be attached to the Special Event Permit Application. The Certificate Holder is the City of Chicago c/o Department of Revenue, City Hall, Room 107, 121 N. LaSalle Street, Chicago, IL 60602. (The organization's existing insurance policy may be utilized to meet this requirement.)

E. Only fill out the sections that pertain to your event although all organizations must fill out the General Information, Security Plan and Site Plan sections of the Special Event Permit Application.

F. First permit application is free. Each subsequent application during that year will cost $35.

NOTE: *Block parties do not require special event licenses. However, you are required to contact your alderman for a permit. Block parties do not receive city services.*

For more information, contact the Mayor's Office of Special Events or see the City's website at http://egov.cityofchicago.org

FUNDRAISING ONLINE

Charitable substantiation rules applicable to cash and quid pro quo donations also apply to donations solicited online.

Most Common Methods:

- Solicitation via an Organization's Website
- "Philanthropy Portals"
- Online Charity Malls
- Merchant Affiliate Programs

Website Solicitations

Most Common method - includes a request for donations directly on the organization's website - "Donate Here" button

Need to address privacy concerns and security issues

Need to consider Multi-State Registration Requirements – currently 39 states require charities to register with them if the charities intend to solicit donations in their respective states. The Unified Registration Statement (URS) represents an effort to consolidate the information and data requirements of all states that require registration of not-for-profit organizations performing charitable solicitations within their jurisdictions. The URS can be used to meet the filing requirements in 34 states and the District of Columbia. The registration forms can be accessed at http://www.multistatefiling.org/.

Regulations (Charleston Principles) have been adopted by National Association of State Charity Officials (NASCO) for the regulation of online solicitations.

Summary of Charleston Principles

Requires a charity or fund raiser that solicits donations over the Internet to register in its home state, assuming the state has such a requirement.

The charity or fund raiser would also have to register in other states if it solicited and received donations through a Web site donation and met one of these conditions:

- Its non-internet activities alone would be sufficient to require registration.
- It “specifically targets persons physically located in the state for solicitation.”
- It “receives contributions from the state on a repeated and ongoing basis or a substantial basis.”
- It sends e-mail messages to residents of the state or contacts them in other ways, specifically to promote its Web site.

For-profit fund raisers would be required to register with all states because they seek contributions from residents in every state in the names of their client charities. Depending on the amounts raised, individual charities might not be required to register in all states. However, there are some states that require a charity to register if commercial fund raisers or fund-raising consultants raise money in their behalf.

The Charleston Principles are available for review online at www.nasconet.org.

Philanthropy Portals

Donations accepted via third party sites
– Usually operated at a separate Web site by the third party
– Might include links on charity’s Web site directly to the third party site

IRS has expressed concern where these third party sites are not being operated by 501(c)(3) organizations, but by for-profit ventures that may be retaining a portion of the donation made to cover the costs of operating the Web site. Earlier IRS rulings did not permit the individual donor a charitable contribution deduction in such instances unless the third party was clearly acting as a collection agent on behalf of a 501 (c)(3) organization.

To act as an agent, the third party intermediary:

- Would not exercise any control over the funds collected
- Keep the charity’s funds segregated from its own monies
- Remit the amounts collected directly to the charity on a frequent basis.

Typically, a written contract should be in place to clearly demonstrate the third party intermediary is acting as an agent on behalf of the charity.

Online Charity Malls

Enable Internet surfers to shop with multiple vendors online, with a portion of their purchases going to one or more charities they designate as part of the online purchase.

Vendors participating in charity malls have agreed, with the mall operator, to remit a certain percentage of their sales to the charities selected by the purchaser.

Mall operators may also retain a portion to cover its Web site costs.

Unless the vendor/mall operator agreement clearly states the mall is acting as the charity's collection agency as described above, then it is likely that the amounts given to the charity will not be treated as charitable contributions.

Merchant Affiliate Programs

Provide links between a charity's Web site and a merchant to facilitate certain purchases (popular with online book vendors.)
Merchant usually agrees to remit a percentage of the purchase price of goods sold via the charity's Web site, back to the organization.

The monies remitted to the charity are not considered tax-deductible contributions, because the purchaser has merely purchased items at their fair market value.

Internet Guidelines

The Association for Fundraising Professionals (AFP) has released "Internet Transaction Guidelines", a set of 22 recommendations that charities can use when they work with Internet-based companies that help them raise money through Web sites or other methods.

Some of the recommendations include:

- Make sure a formal written agreement is in place with all companies that represent the charity or accept donations on its behalf.
- Make clear which party (the charity or the Internet-based company) is required to register with appropriate regulators.
- Specify who has legal control of charitable contributions
- Detail all fees that the company charges against each gift to the charity, including transaction," "after transaction," and "account management" fees.
- Make clear whether the provider is capturing demographic information about donors during transactions or in surveys after a donation has been made, and if so, who owns the data. If the information is collected, the company should clearly and readily disclose that fact to potential donors and other visitors to its Web site.

PROPER ACCOUNTING FOR GIFTS

Generally Accepted Accounting Principles governing contributions are found in the Statement of Financial Accounting Standards (SFAS) No. 116, *Accounting for Contributions Received and Contributions Made*. These accounting principles were adopted for all organizations in 1995. They significantly changed how not-for-profit organizations must account for contributions. Accounting for donations is best served when all income is tested for five questions:

1. Does the income represent a contribution, earned revenue, or some combination of both?

2. Does contribution income represent income to the organization, or are they acting as a pass-through entity for contributions made to another group?

3. Is the contribution income accompanied by restrictions and/or donor conditions?

4. Has the organization received promises of future support (pledges) from donors? If so, are these pledges conditional or unconditional?

5. Does the organization receive support in the form of volunteer labor or pro bono professional services?

Not-for-profit organizations must segregate their charitable contributions income from all other forms of earned income and earnings from investments. This is required not only by accounting rules, but also for filings with governmental agencies.

Accounting rules define a contribution as a transaction in which the donor receives no benefits in exchange for the assets transferred to the organization and it is made or received voluntarily.

Our discussion today is limited to those transactions we can classify as "contributions," and addresses the issues surrounding how we raise those funds through a variety of methods.

WHEN IS A GIFT A GIFT?

A contribution or gift may be in the form of cash or cash equivalents, securities, property -- real or personal, pledges, grants, or even donated services. Proper recording of the contribution depends on the nature of the gift, and varies on whether you are the donor (giver) or the donee (recipient).

For the not-for-profit organization or donee, a contribution should be recorded when the organization has constructive receipt of the gift. This does not necessarily mean that the organization has cash in hand, only that they have the ability to use the gift. We will cover examples of this concept under each category of gift.

For the giver or donor, the gift should be recorded when the donor relinquishes control of the asset being donated. Again, different rules apply depending on the nature of the gift. We will explain these as we cover each category of gift.

The fact that different rules apply to the donee and the donor will inevitably lead to differences between what the recipient organization records on its books and records, and what the donors record on their tax returns. While this is not the concern of the organization, the organization should understand the differences, be able to give an overview explanation to donors (with appropriate disclaimers), and suggest that donors consult their own tax counsel.

The organization's main concerns are that it a) properly records gifts according to the rules that apply to it, b) gives the donor appropriate documentation, and c) uses the gift according to the wishes of the donor.

TYPES OF GIFTS

Under accounting rules, all of the following categories of contributions are recognized as support (income) at the time the gift is made:

1. Unrestricted contributions of cash or non-cash assets
2. Certain contributed professional services
3. Unconditional promises to give – commonly referred to as pledges
4. Restricted contributions (temporary or permanent)

Cash Gifts

Cash and cash equivalents may be considered as personal checks, money orders, cashier's checks, certified checks, or credit card payments. They may also be the rights to certain bank accounts such as money market funds or certificates of deposit.

While the general rule for the donee is that cash equivalents are considered gifts when received, the skeptic lives by the credo that a gift is not a gift until the check clears the bank. For accounting purposes, it is generally safe to consider cash equivalents as gifts when the organization receives them. Recording does not wait until the gift is deposited, unless the donor has issued post-dated checks for their donation.

The IRS requires donors to obtain a substantiating document from the not-for-profit organization for all cash gifts, regardless of the amount, in order to claim a deduction on their tax return. The IRS also requires the not-for-profit organization to issue a "quid pro quo" letter for gifts or benefits received by the donor in exchange for their donation, that are valued in excess of $75. This communication must be in writing to the donor. A good example of this is a fundraising dinner. The charge may be $150 per plate, but the actual cost of the dinner is $35. The donor should receive a letter from the organization indicating a $115 donation and $35 given in exchange. This can also be done on the face of the dinner invitation by saying the tax-deductible portion of the donation is $115.

As a matter of good fundraising tactics, it is a good idea to issue a letter to every donor for every donation. This accomplishes two very important tasks. First, it satisfies all substantiation rules. Second, it allows the organization to keep its donor mailing list updated.

Gifts of cash in the form of real cash are rarely received by mail. They are, however, common at the time and location of a fundraising event, i.e. paying at the door. Two things make good sense for the organization. The first is to have pre-printed receipts in the form of "quid pro quo" letters available, where all that needs to be filled-in is the donor's name and address. The second is for the organization to make these out in duplicate and retain a copy.

Non-Cash gifts -- Cash and Cash Equivalent Gifts

There are many forms of non-cash gifts, each with their own set of rules. We will try to cover the most common, indicating both the rules for recipients and rules for donors.

Stocks, bonds and other securities

Donation of appreciated securities has become very popular because of favorable IRS regulations. Donors can take a deduction for the fully appreciated value of the stock without having to pay taxes on the capital gain that was earned. This makes it an appealing choice for the donor.

The not-for-profit organization should record all securities as gifts when received. Usually this is when the transfer is credited to the organization's brokerage or investment account. On some occasions, the donor may physically deliver the securities or stock certificates directly to the not-for-profit recipient organization. In this case, the exact date on which the securities were received becomes very important. The not-for-profit organization should record the securities received as a donation valued at the closing market price on the day they were received.

In cases of donated securities, the written acknowledgment issued to the donor will be somewhat different than the recording of the gift for accounting purposes. The acknowledgment should <u>not</u> indicate a value for the securities. It should merely state the number of shares or face value of the bond, the name of the security, and the date received. This is because the donor's tax deduction will probably be a different dollar amount than the closing price used to value the donation on the not-for-profit's books. If you can substantiate that the donor relinquished control on a date different than the day you received the security, then you should indicate the date the donation was made on the acknowledgment.

When contributing appreciated securities, the donor is entitled to a tax deduction equal to the average of the high price and the low price of the stock on the day they made the donation. Because securities may be ordered for donation after the close of the markets on a particular day, it is possible that the day of the donation for the donor may be a different day than the day received. It is also possible that the physical security certificates may be mailed to the recipient, in which case the mail date is the donation date for purposes of the donor's tax return.

It is important to note that if the not-for-profit organization subsequently sells the security at either a gain or a loss, the donor's tax deduction is not affected. The not-for-profit should record the gain or loss on the organization's records based on the sale price compared to the value on the day the organization received the donation. All capital gains, even if for securities held in the permanently restricted fund, are most times considered unrestricted and may be used any way the organization chooses. Gains and losses related to securities are not classified as gifts in the financial records, but are instead recorded as investment earnings.

<u>Real Property</u>

Donations of real estate are also considered gifts. The value of these gifts should be determined by a qualified independent market appraisal. A qualified appraisal is required when the value of the real property gift is $5,000 or more. The appraisal must be done within 60 days of the gift and must be done by an individual whose trade or business is appraising real property. The appraiser must have no relationship to the donor or donee organization and must sign Part III – Declaration of Appraiser on Form 8283. When the value of the contribution is $500,000 or more, the qualified appraisal must be attached to the tax return in which the deduction is taken. Unless the property is sold within the same fiscal year received, the property becomes a long-term asset of the organization. Receipts given to the donor should include a full description of the property. If a value is stated on the receipt, it should clearly state how the value was determined. Special rules apply if the property is income producing. You should refer to the IRS Publication 561 – *Determining the Value of Donated Property* (included in these reference materials) for further details, or seek professional advice on issues related to real property gifts.

<u>Charitable Remainder Trusts</u>
A Charitable Remainder Annuity Trust (CRAT) and a Charitable Remainder Unitrust (CRUT) allows the donor to receive an income stream based on their life expectancy with a charitable deduction for the remainder interest that is passing on to a qualified charity.

<u>Charitable Lead Trusts</u>

A Charitable Lead Annuity Trust (CLAT) and a Charitable Lead Unitrust (CLUT) allows the donee organization to receive an income stream based on the expectancy of the donor with the donor receiving the remainder interest at the conclusion of the term.

Donor Advised Funds
A donor advised fund enables donors to gain an immediate tax deduction along with the ability to support charities on a flexible timetable. The funds are available for charitable giving now, or in the future. These contributions have the opportunity to grow in investment options managed by the mutual fund company sponsoring the donor advised fund.

Personal Property

Donations of personal property are also gifts. They generally fall into one of three categories:

1. Vehicles – the value for purposes of a donation depends upon what the charity does with the donated vehicle. If the charity receives a car donation that is valued over $500 and the car is sold, the donation is based on the gross amount the charity receives. If the charity intends to use the vehicle for their own purposes, then the contribution may be valued based on information from NADA, Kelley Blue Book and Edmunds Drivers Guide. IRS Form 1098-C is used to report contributions of Motor Vehicles, Boats and Airplanes under the new law.

2. Collectibles and Valuable Papers – may include art of any type, stamps, coins, sports trading cards, autographs, rare books and maps, antiques of almost any type, or anything else considered collectible. Antique or collectible vehicles will usually fall into this category, rather than the vehicle category. As is the case with real property, a qualified independent market appraisal determines the value of the donation and is required if the value of the contribution is $5,000 or more. A qualified appraisal is required to be attached to the donors' tax return if the value of the contribution exceeds $500,000. The receipt issued should follow the same rules as for real property. That is, if a value is stated, the acknowledgment should clearly state how the value was determined.

3. Household Items – normally given to thrift stores. The Pension Protection Act of 2006 toughens the rules for non-cash donations. Donated items, such as clothing and household goods, must be in good condition. No tax deduction is allowed for items in less than good condition. Unless the total donated during a calendar year exceeds $5,000, the donors place their own value on the donation. The obligation for the recipient organization is to issue a receipt describing the items donated without stating a value.

It is important to note that when necessary, it is customary for the donor to pay for the qualified independent appraisal. The recipient organization should not be involved determining the value of the donation.

IRS Forms related to donation of property include:

- **Form 8282** – Not-for-profit organizations use this form to report information to the IRS about dispositions of certain charitable deduction property made within 2 years after the donor contributed the property. The form must be filed within 125 days after the date of the disposition.
- **Form 8283** – Donors must file this form if they wish to deduct noncash gifts of more than $500. Form 8283 is filed with the individual's tax return for the year the property was contributed.

Copies of both forms, along with instructions, are included in the reference materials.

Donated Services

SFAS No. 116 provides guidance on when donated services should be recognized as contribution income (and as assets or expenses) in the financial statements. In general, donated services should be recognized in the financial statements if the services either a) create or enhance a non-financial (non-monetary) asset or b) require specialized skills, are provided by entities or persons possessing those skills, and would need to be purchased if they were not donated. Services that do not meet either of the preceding criteria should not be recognized. Donated services that create or enhance a non-financial asset, such as constructing a new facility, do not need to be specialized in order to be recognized.

Donated services are to be recorded at their fair value. If a reduced fee is charged, the fee that is recognized as a donation is the difference between the reduced fee and the fee that would have been charged in an arm's length transaction. The standard billing rate charged by many professionals may not be representative of the fair value. Fair value should be determined based on what other entities would pay for similar services.

Services typically requiring specialized skills are provided by attorneys, accountants, physicians, nurses, electricians, plumbers, architects, teachers, and other professionals and craftspeople. Some examples of recordable services include pro-bono legal, accounting, medical, investment advisory services, or computer consulting services.

Although board members often possess specialized skills, the value of their services should only be recorded if they are used in connection with a building or renovation project or if they would be purchased if not donated.
The organization should consider whether it would otherwise need to purchase the services, not whether it could afford to purchase the services at their fair value. The following factors might indicate the organization would need to purchase the services if they were not donated:

- The services represent an integral part of the organization's programs.
- The services are required to fulfill part of the organization's ongoing administrative requirements, such as preparation of the organization's Form 990.
- Volunteer services make up a significant part of the organization's total program activities.
- Similar services are also purchased from third parties when volunteer services are not available.

Many organizations rely on volunteers to provide routine services, such as administrative tasks (e.g., filing or answering the telephone) or assisting in staffing of fundraising events. Since those services neither create nor enhance a non-financial asset nor do those services require specialized skills, the value of those services would not be recognized as a contribution. Other examples of non-recordable donated services include stuffing envelopes for mailing and data entry of donor names and addresses on a mailing list.

Most promises to give services will usually be conditional promises to give that should not be recognized in the financial statements. However, organizations should disclose those conditional promises in the notes to the financial statements.

SFAS No. 116 requires organizations receiving donated services to disclose the activities or programs for which those donated services were used, including the nature and extent of those services, and the amount recognized as revenue during the period. Similarly, organizations are encouraged to disclose the amount of donated services received, but not recognized as revenue if it is practicable to do so. For example, an organization may want to disclose the number of volunteer hours received during the year and their estimated fair value.

When recording donated services, the organization records an equal amount to either an asset or expense. If to expense, recording donated services has no effect on the change in net assets (recorded on the statement of activities).

It is important to note that amounts recorded in the financial statements for donated services are eliminated when preparing an organization's Form 990. The IRS does not consider the value of donated time to be either reportable as income or expense.

For the donor of the services, a very similar rule applies. A donor may not take a charitable deduction for the value of time donated, or for the value of any discount given to an organization. Donors may, however, deduct out-of-pocket expenses related to their donated services that are not reimbursed by the organization, including travel costs at $0.14 per mile (2011).

Unconditional Promises to Give or Pledges

SFAS No. 116 describes a contribution as an unconditional transfer of assets or settlement of liabilities in a voluntary nonreciprocal transfer. Transferred assets may be cash, securities, property, use of facilities or utilities, materials and supplies, services, and unconditional promises to give those items in the future.

When accounting for contributions, it is important to distinguish them from other transactions and arrangements, such as the following:

Intentions to Give – Intentions to give are merely statements of an expressed interest in giving. Intentions to give are not recorded unless legally enforceable. For example, bequests included in wills are intentions to give because the donor has the right to modify or change the will. The intention to give changes to an unconditional promise when the will is validated after the donor's death.

Exchange Transactions – Exchange transactions are reciprocal transfers in which each party receives and sacrifices something of approximately equal value, such as program service fees and sales revenue.

Agency or Intermediary Transactions – Agency or intermediary transactions are transfers of assets in which the organization acts as an agent or intermediary. SFAS No. 136, *Transfers of Assets to a Not-for-Profit Organization or Charitable Trust That Raises or Holds Contributions for Others*, establishes standards for transactions in which a donor transfers assets to a recipient organization that a) uses the assets on behalf of or b) transfers the assets, the return on investment of the assets, or both, to a beneficiary named by the donor as well as standards for revocable or reciprocal transfers that are not contributions.

Conditional Promises to Give - Conditional promises to give are not recorded in the financial statements. Conditional promises should be recorded when the conditions on which they depend are substantially met, that is, when the conditional promise becomes unconditional.

SFAS No. 116 generally requires measuring contributions received and promises to give at their fair value. Contributions received and promises to give are reported as an increase in net assets at the time of pledge or promise is received (regardless of when the cash is received).

Promises can be written or oral. Before a promise to give can be recognized, sufficient verifiable evidence should exist documenting that a promise was made by the donor and received by the not-for-profit organization. Such evidence may be included in written or verifiable oral communications, including a) written agreements, b) pledge cards, and c) oral promises documented by tape recordings, written contemporaneous registers, follow-up written confirmations, and other means that permit subsequent verification of the oral communications. Documentation should include the name, address, and telephone number of the donor, amount of the promise, due date, the date the promise was made, and the name of the organization's employee or representative to whom the promise was made. A communication that does not indicate clearly whether it is a promise is considered an unconditional promise to give if it indicates an unconditional intention to give that is legally enforceable. Promises to give that do not discuss the specific time or place for the contribution but that are otherwise clearly unconditional in nature should be considered unconditional promises to give.

The full amount of the pledged gift is recorded as a contribution to the not-for-profit organization in the fiscal year the promise was made, even if no payment has been received, and even if the gift covers payment over many years. For example, a pledge to pay a gift of $1,000,000 over ten years is still recorded as a $1,000,000 gift in the fiscal year made. However, accounting rules recognize that there is a time value to money. Therefore, a second entry reduces the value of the gift in the current year by the difference between the full amount of the gift and its present value today. Organizations may use the present value of future cash flows as one valuation technique for measuring the fair value of contributions expected to be collected one year or more after the financial statement date.

Revocable and Irrevocable Bequests

When dealing with gifts coming from the estate of a deceased donor, the key factor is whether the gift is revocable or irrevocable.

Revocable bequests are not recorded as gifts until a donor becomes deceased and settlement of the estate indicates that the bequest will be received.

With an irrevocable bequest, there is no possibility of change. Generally, in order to record a future bequest as a gift, some mechanism must have been set up to preclude any changes. An irrevocable trust, pre-funded with the gift, is an acceptable mechanism.

The future recipient (the not-for-profit organization) records the full amount of the bequest as a gift in the year the mechanism is created. In order to account for present value, the donee organization uses a formula that includes the life expectancy of the donor. The IRS publishes life expectancy tables that may be used for this purpose.

Restricted Contributions

Restricted contributions are those gifts in which a donor stipulates how the donated funds are to be used. SFAS No. 116 makes an important distinction between restricted contributions and conditional promises to give as it relates to time of recognition. Restricted contributions, along with unrestricted contributions, are recognized as contribution revenue in the statement of activities when the contribution is made (e.g., when the pledge or promise is received). Unlike contributions, conditional promises to give are those which depend on the occurrence of a specified and uncertain event to bind the prospective donor. Since the gift is uncertain, conditional promises to give are not recognized as contribution revenue until the gift becomes unconditional (e.g., when the conditions have been met).

Donor's Intent

A donor's restriction on a gift becomes active when the recipient donee organization accepts the gift. No one may change the restrictions except the donor, or in some cases, a court. The Board of an organization may not change the restrictions placed on a gift by a donor. In rare cases, the organization may no longer be able to meet the donor's restrictions. This may be the case if the organization ceases operating the program funded by the donor. In this situation, the organization should contact the donor and discuss modifying the restrictions. An example of this could include a scenario where a now deceased donor provided scholarship funding for needy undergraduate students to a local college. The college in question made a decision to cease its undergraduate program and now concentrates only on graduate studies. The college was able to obtain a court decision to modify the donor restriction so that it could now apply the scholarship for graduate students.

Types of Restrictions

There are two types of restrictions provided for by accounting rules – temporarily restricted and permanently restricted. The recipient donee organization, through its Board and staff, has the fiduciary responsibility to comply with donors' restrictions.

Temporarily restricted means that a donor has placed restrictions on the use of their gift either as to time and/or as to purpose.

A good example of a gift restricted as to time is a multi-year pledge. The gift is recorded as income when the pledge is made, but obviously cannot be used to fund expenditures until the donee organization receives the cash payments from the donor. Another example is a gift of cash restricted for use over several fiscal years.

Donors may also place restrictions on their gifts so that they go toward funding specific programs. These gifts are examples of gifts restricted as to purpose and funds should not be used to cover expenditures until the restriction is met.

There are three important factors to note about temporarily restricted gifts:

1. The gift is recorded when received or pledged or grant awarded and reported in a separate accounting category until the restrictions are met.

2. A donor restricting the gift for a certain purpose is restricting the use of the revenue, not the individual expenditures that fulfill that purpose (unless specifically stated in the restrictions).

   For example, a gift funding a Thanksgiving dinner for the homeless would not usually require using the money for certain foods or accessories.

3. The donors' money must be spent first in fulfilling the restriction.

A permanently restricted gift is, as its name implies, permanent. This means that the principal or corpus of the gift may not be spent at all. The organization has the fiduciary responsibility to invest the gift to accomplish at least two purposes:

1. To preserve the principal intact, and/or

2. To invest the gift so that the earnings are always sufficient to fulfill the purpose intended by the donor. This usually means earning enough to fulfill the donor's purpose and offset any inflation that may erode the organization's ability to fulfill the donors' purpose in the future.

It should be noted that if the principal ever falls below the original value of the donors' gift, there is a fiduciary responsibility to replenish that amount from unrestricted funds.

Additionally, borrowings from the permanently restricted gift are not permitted unless specifically allowed by the donor. However, the organization may usually invest the gift in any reasonable and prudent manner.

In some cases, a donor may insist that the gift be invested in a certain manner and that all earnings and capital gains be applied to the intended purpose. The organization then must make a determination as to whether it can fulfill the donor's purpose with these restrictions. If it cannot, then a negotiating process must take place before the organization should consider accepting the gift.

Foundation and Government Grants

Many foundations and government grants are recorded as temporarily restricted gifts because the use of these funds is restricted to certain programs or projects. Grants are many times payable over multiple years or dependent on matching funding being obtained. In some cases, payment of grants merely depends upon filing perfunctory reports to the foundation or government agency. In other cases, substantiating documentation is required before the grantor issues all of the funds. When, and how much of a grant is recorded, depends upon many factors.

If the requirements for obtaining the actual funding are minimal or easily expected to be fulfilled, then a grant may be recorded as revenue when the recipient organization receives notice of the grant award. Recording the gift discounted for present value will apply if the grant will be paid over multiple years.

If funding depends upon some specific action by the recipient organization and/or must be documented in detail before funds are issued, then recording the gift should be deferred until the organization has substantially fulfilled the requirements. A typical example is a government reimbursement grant, or a matching grant. This is true even if the grant award is funded in advance. In that case, the cash received should be recorded as deferred revenue (liability), potentially refundable to the grantor (if the conditions are never fulfilled).

Capital Projects

Special rules apply to fundraising for capital projects depending on whether they are financed with conventional debt (bank loans), or tax-exempt debt (bond issues). Typically, banks will be willing to advance funds for a capital project, or guarantee tax-exempt bonds after fundraising reaches a certain percentage of the cost of the capital project. This is because a not-for-profit organization has the ability to borrow at lower tax-exempt rates, but invest donations at higher taxable rates.

The exact wording that accompanies a donation for a capital project is critical in determining if that donation a) must be used directly to pay expenses for the project, b) can be invested and used as collateral for a loan, or c) can be invested and the income used to pay debt service on a tax-exempt bond issue.

It is important to get professional advice before embarking on a capital project, especially if the project is to be funded through fundraising.

DEVELOPING FUNDRAISING MATERIALS FOR DIRECT MAIL

Not-for-profit organizations often incur costs for materials or activities that include elements of both program services (or management and general services or membership development) and a fundraising appeal. Examples of joint activities are mail solicitations such as a brochure or newsletter, radio or television program spots, free seminars, etc. The question is whether the costs of such joint activities should be reported entirely as fundraising or should be allocated between fundraising and program services (or management and general services). Statement of Position (SOP) 98-2, *Accounting for Costs of Activities of Not-for-Profit Organizations and State and Local Governmental Entities That Include Fund Raising*, applies to all not-for-profit organizations that solicit contributions.

SOP 98-2 begins with the underlying presumption that, in circumstances in which joint activities are conducted, expenses should be reported as fundraising expenses rather than as program services or management and general or membership development expenses, unless <u>all</u> of the following criteria are met:

1. Purpose – If the activity is to be considered a program activity, it must call for specific action by the audience that will help accomplish the organization's mission.

2. Audience – If the audience does not include prior donors and is not selected based on the likelihood of the recipients to contribute to the organization, the audience criterion is met if the audience was selected for one of the following reasons: a) the audience should have the need or reasonable potential need for the actions called for by the program component of the joint activity, b) an ability to take action to assist the organization in meeting the program goals of the joint activity, and c) a requirement imposed on the organization to direct some management and general activity to that audience or the audience has a reasonable potential need for the management and general component. As such, the source of the names and characteristics of the audience should be carefully considered prior to engaging in the joint activity.
3. Content – The joint activity must either a) call for specific action by the recipient that will help accomplish the organization's mission or b) fulfill one or more of the organization's management and general obligations. Actions to help accomplish the organization's mission are those actions that either benefit the recipient (such as by improving the recipient's physical, mental, emotional, or spiritual health and wellbeing) or benefit society (by addressing societal problems).

The following factors should be considered in order to determine if the joint activity meets the purpose criterion:

a. Whether the organization substantially bases the compensation or fees for any party performing part of the activity on something other than the amount raised.
b. Whether the organization conducts a similar program (or management and general) activity with the same medium and on a similar or greater scale.
c. Other available evidence including: a) considering if the program results of the joint activity are measured, b) determining whether a different medium is used to conduct the program or management and general part of the activity without fundraising being a significant part under that medium, c) considering how employees, consultants, or other parties contributing to the activity are evaluated and compensated, d) considering how the organization evaluates results from the activity (for instance, if the organization is interested in evaluating program goals or if the organization is more interested in fundraising goals), e) evaluating the qualifications or duties of third parties or employees performing the activity (for example, whether employees

performing the activity primarily devote their time to program services as opposed to fundraising), and f) other tangible evidence such as the organization's mission statement and long-range plans, minutes of board meetings, donor-imposed restrictions on gifts to fund the activity, correspondence with consultants or other parties about the activity's purpose, or internal memos.

If all three criteria are met, the organization should first charge costs clearly identifiable with a fundraising, program, management and general, or membership development function to that function and then allocate the activity's joint costs (such as printing, packaging, mailing list rental fees, postage, etc.) among the functions. If any of the criteria are not met, all of the costs related to the joint activity should be reported as fundraising expenses.

Joint activities that are incidental to the primary fundraising, program, or management and general activity and meet the criteria of SOP 98-2 for allocation are not required to be allocated. Instead, those joint costs may be reflected in the same functional classification as the primary activity.

SOP 98-2 does not mandate the use of any particular method of allocating costs to joint activities. As long as the method is "rational and systematic", and it results in a "reasonable" allocation of costs, it may be used.

Once an allocation method is adopted for a particular activity, however, it should be applied consistently.

SOP 98-2 requires disclosures related to the types of the activities for which joint costs have been incurred, a statement that joint costs have been allocated, the amount of total costs allocated, and the portion allocated to each functional expense category.

Organizations should be cautious in designing their direct mail pieces if they wish to allocate some of the costs involved to program services (or management and general). Organizations may want to consider segregating fundraising activities from program activities in order to avoid these rules. Organizations should refer to the complete text of SOP 98-2 and/or consult your accountant for further details on allocating joint costs.

UNDERSTANDING CORPORATE SPONSORSHIPS - IMPLICATIONS, CONTRACTS, AND TAX ISSUES

For the last decade, corporate sponsorship income has been the subject of scrutiny by the Internal Revenue Service and Congress. The IRS recognized that non-profits were earning significant revenue from corporate sponsorship, and issued guidelines which would have made virtually all corporate sponsorship income taxable. Thanks to some quick and effective lobbying on the part of charities, the Internal Revenue Service changed its position and issued regulations which make many types of corporate sponsorship income tax-free. The regulations were codified in 1997. By following a few simple rules, a non-profit has great flexibility in accepting tax-free corporate sponsorship revenue.

Definition of Corporate Sponsorship.

Corporate sponsorship is financial support by an outside party, usually a corporation, for the good works of a non-profit organization. It is distinguished from a charitable contribution in that a

corporate sponsor is typically motivated by a desire to receive a public acknowledgment in exchange for its support. For example, the cereal companies and camera film manufacturers that pay the

Olympics Committee for the right to put “Official Sponsor of the Olympics” on their products would be treated as corporate sponsors, rather than charitable donors.

Basic Rules

The law permits a non-profit to receive corporate sponsorship income tax-free if what is given the corporate sponsor in return for its payment is an acknowledgment of thanks. This acknowledgment can take a variety of forms. The non-profit can hang a banner in its headquarters, or in the room where the sponsored event is taking place. It can take space in a conference program to thank the sponsor, or the staff or volunteer leaders can stand at a podium and thank the corporate sponsor. The acknowledgment of thanks can list the corporate sponsor’s name, logo, address, telephone number, and products. The corporate sponsor can distribute samples of its products at the sponsored event. In short, the law places few restrictions on the format of the acknowledgment of thanks.

Prohibitions

There are, however, two important prohibitions. First, the non-profit cannot make a qualitative judgment on the corporate sponsor’s products or services. This means that acknowledgments of thanks should not contain comparative language or language that implies good quality. Words like “best”, “finest”, “top-notch service”, and the like must be eliminated from any copy which will be included in an acknowledgment of thanks for a tax-free payment. This can usually best be achieved if the non-profit writes the acknowledgment of thanks, rather than permitting the corporate sponsor to write its own copy.

The second prohibition is that the non-profit cannot ask its members or the public to buy the products or services of the corporate sponsor. Even an innocent phrase like “please patronize our sponsors” could jeopardize the tax-free nature of the corporate sponsorship payment.

Endorsements

One item which a non-profit may not provide without allocating a portion of its revenue as taxable income is an endorsement. An endorsement would be considered as a request for members of the public to buy the product or service of the corporate sponsor. Endorsements also carry product liability, public relations, and other risks. Many non-profits use the taxability of corporate sponsorship income when exchanged for an endorsement as a good reason to tell their corporate sponsors that providing an endorsement of the product or service is simply out of the question.

Periodicals

The 1997 codification of the corporate sponsorship law contained a troublesome addition. It states that, if the acknowledgment of thanks were contained in a periodical which was not published in connection with a sponsored event, the corporate sponsorship payment would not qualify for tax-free treatment. This seems even less logical than the typical Internal Revenue Code provision. Why prohibit acknowledgments in periodicals, when such great flexibility is otherwise permitted? Recent pronouncements show that the IRS is rethinking this point and more flexible guidance may be issued in the future. In the meantime, acknowledgments in periodicals should be tied to some special event, like a sponsored conference or educational program. For example, “we wish to thank the following companies, which are providing corporate support for our upcoming conference ...” might be published in a special conference edition of a newsletter.

Allocations

The 1997 law added a very helpful aspect of flexibility to the rules. If a non-profit violates one of the rules, the entire corporate sponsorship payment will not necessarily be taxable. Only a portion would be taxable, which is fairly allocable to the value of the taxable benefit provided to the sponsor. For example, if a non-profit received a $10,000 sponsorship payment in return for a banner at the sponsored event and a half-page ad in the conference program, only a portion of the $10,000 would be taxable. That portion would be determined by the fair market value of the half-page ad, which may be easy to value based on how much other advertisers paid for similar space.

If the non-profit knows at the time the deal is struck that a portion of the payment will be taxable income, but the value is not easy to estimate, it may wish to consider valuing that item in the contract or other written agreement with the corporate sponsor, to avoid having the IRS later assign too great a value to that portion of the consideration.

Substantial Return Benefits

Regulations issued in 2000 defined "substantial return benefits." To the extent of the value of a sponsor's substantial return benefit, the sponsorship payment will not be exempt from UBIT.

A substantial return benefit is "any benefit other than goods, services, or other benefits of insubstantial value" received by the sponsor in consideration of its payment. For example, if a sponsor receives free advertising, certain facilities or privileges such as complimentary event tickets or products, or a license to use an intangible asset such as a logo, the sponsor may have received a substantial benefit return. The exempt organization must pay tax on a portion of the sponsorship payment, measured by the fair market value of the substantial return benefit.

Exclusivity

The regulations make a distinction between exclusive sponsorship arrangements and exclusive provider arrangements. In an exclusive sponsorship arrangement, the exempt organization acknowledges the sponsor as the exclusive sponsor of a specific activity. These arrangements generally do not create a substantial return benefit. Note that exclusive provider arrangements could create UBIT.

Web Sites

The regulations state that a non-profit may thank its corporate sponsor on its web site and link to the corporate sponsor's home page without allocating a portion of the corporate sponsorship revenue to taxable income.

Corporate sponsorship has become big business for non-profits. Large and small non-profits alike are seeking and receiving significant revenue from companies that want to have their names associated with the good works of the non-profit organizations. By attending to a few details up-front and keeping the basic rules in mind, non-profits can avoid paying tax on their corporate sponsorship revenue and keep more dollars in their coffers to carry on their educational, charitable, professional, and other non-profit programs.

Illinois Attorney General's Office
http://www.ag.state.il.us/charities/index.html

Internal Revenue Service – Tax Information for Charities and Other Non-profits
http://www.irs.gov/charities/index.html

Internal Revenue Service – Compliance Guide for 501(c) (3) Public Charities
http://www.irs.gov/pub/irs-pdf/p4221pc.pdf