



Model Incorporation and Tax Exemption Documents for California Non-Profits

Chapter 1 – Forming a California Non-Profit Public Benefit Corporation

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WHETHER TO INCORPORATE

Alternatives to Forming a New Nonprofit, Tax Exempt Charitable Corporation

Before forming a new charity, consider the alternatives: (1) forming an unincorporated nonprofit association or (2) operating as an informal organization under the legal umbrella of an existing charity (often called fiscal sponsorship).

I. Unincorporated Nonprofit Association vs. Nonprofit Public Benefit Corporation

A. Advantages of Association

1. Need not prepare formal organizational documents or follow formal meeting procedures. No formal procedure to dissolve or disband.
2. No incorporation costs.
3. No ongoing filing and reporting requirements or government scrutiny.

B. Disadvantages of Association

1. Lack of limited liability protection for members.
2. Difficulty in contracting or otherwise doing business in the associational name.
3. Difficulty in raising grants, contributions, and other funds.
4. Lack of clear authority or management structure. With informal membership, may be less able to claim to represent a constituency.
5. May be treated as a legal entity for tax purposes, and if so, must file partnership or corporate tax returns and may have to pay tax on net income.

II. Fiscal Sponsorship vs. Nonprofit Public Benefit Corporation

A. Advantages of Fiscal Sponsorship

1. Can raise grants, contributions, and other funds through the sponsor. Track record and experience of the sponsor may assist in obtaining outside financial support.
2. The sponsor has fiscal, accounting, personnel, management and other systems in place.
3. Can operate informally as described above; no incorporation costs.
4. The sponsor assumes the risk of liability.

B. Disadvantages of Fiscal Sponsorship

1. Loss of control over activities, since ultimate authority is the board of directors of the sponsor.

2. Perception within community that the activities are those of the sponsor. The sponsor may receive credit for a successful project. A sponsor with a bad reputation may tarnish the project.
3. As a small part of a larger organization, the project might not receive adequate support in a timely manner. Also, the sponsor might retain a significant portion of the funds for its administrative expenses.
4. May be difficult to disengage from the sponsor and continue the project in a separate corporation.

The remainder of this Packet assumes that the organization prefers to incorporate as a new charity.

THE INCORPORATION PROCESS

Nonprofit incorporation is largely a paperwork task. An organization receives the right to corporate status by filing the required papers and forms—Articles of Incorporation—with the Secretary of State. Obtaining tax-exempt status is a separate process requiring application to the federal Internal Revenue Service (IRS) and California Franchise Tax Board (FTB).

The following outline summarizes the steps in both the incorporation and tax-exemption application processes.

More information:

- The [Secretary of State's business website](http://www.sos.ca.gov/business/)¹ offers resources such as instructions for preparing and filing incorporation- and other documents, tax and fee information, sample forms, and filing tips
- The [Franchise Tax Board's website](http://www.ftb.ca.gov/)² offers tax information relevant to nonprofits and incorporation
- The [Attorney General's website](http://oag.ca.gov/charities)³ includes a guide to nonprofit formation
- The [IRS's website](http://www.irs.gov/Charities-&-Non-Profits/Charitable-Organizations)⁴ provides tax information for charitable organizations

Reserve Name with Secretary of State. Reservation Fee = \$10.

The sample Articles of Incorporation in this packet includes a blank for insertion of the corporate name. It is best to reserve a corporate name before filing the Articles of Incorporation. See the sample Name Reservation Request letter and the Name Reservation Request Form.

- Check the availability of a corporate name by mailing an inquiry to the Secretary of State's office in Sacramento.

¹ <http://www.sos.ca.gov/business/>

² <http://www.ftb.ca.gov/>

³ <http://oag.ca.gov/charities>

⁴ <http://www.irs.gov/Charities-&-Non-Profits/Charitable-Organizations>

- Note that checking the availability of a corporate name does not reserve the name or confer any rights to the name, and has no binding effect on the Secretary of State.
- A name may be reserved from the Secretary of State for a period of 60 days.
- The reservation can be renewed, although there must be a lapse of at least one day before renewal.
- The name reservation request can be made (1) over-the-counter at any Secretary of State office, (2) by writing to the Sacramento office, or (3) over the telephone by a person who has a Secretary of State Corporate Prepay Priority Telephone Services account.
- The reservation fee is \$10.00.
- If the reservation is made over-the-counter, a \$10.00 special handling fee must be remitted by separate check. This fee will be retained whether the proposed name is accepted or denied for reservation.

The Secretary of State will not file the Articles of Incorporation if the proposed corporate name is likely to mislead the public because it is the same as, or too closely resembles the name of a registered corporation or a name that is under reservation for another corporation. The name may be similar to the name of an existing corporation if the existing corporation consents in writing to the use of the name and the Secretary of State finds that, under the circumstances, the public is not likely to be misled.

Examples:

- **R.I.S.E. (Riding Instruction for Special Equestrians)** and **Rise, Inc.** are not deceptively similar to each other and do not require consent.
- **Sampson, Incorporated, Sampson Corporation** and **Sampson Ltd.** are deceptively similar to each other.
- **The Long Co.** and **Long Co.** are deceptively similar to each other
- **A B C Corp, AB C Corp., A.B.C. Corp.** and **A-B-C Inc.** are deceptively similar to each other.

Prepare and File Articles of Incorporation. Filing Fee = \$30

Insight Center's [California Model Articles of Incorporation for Nonprofit Public Benefit Corporation](http://www.insightccd.org/uploads/publications/legal/ch2-articles_of_incorporation.pdf)⁵ contain the minimum required provisions and are designed to provide the corporation as much flexibility as possible consistent with obtaining a "charitable" tax exemption. Additional provisions can be included. Make sure to include the corporation's street address and mailing address. An attorney should prepare or review the Articles of Incorporation before they are filed. Some key provisions include:

Purposes Clause

In consultation with an attorney, replace the clauses in Article II (A) of the Insight's Center Model Articles of Incorporation with one or more paragraphs concerning the organization's intended charitable purposes. See Obtaining Tax Exempt Status for more information on charitable purposes.

⁵ http://www.insightccd.org/uploads/publications/legal/ch2-articles_of_incorporation.pdf

Agent for Service of Process

The Articles of Incorporation must set forth the name and California street address (if an individual; if a corporation, no address should be listed) of the corporation's initial agent for service of process, to facilitate service of legal process on the corporation. The agent is often the incorporator or another officer or director of the corporation. A PO Box address is not acceptable.

Initial Directors or Incorporator(s)

The Articles of Incorporation may be signed by either the initial board of directors or an incorporator.

The Insight Center's Model Articles of Incorporation provide for a sole incorporator rather than a first board of directors. The incorporator signs the cover letter and the Articles of Incorporation. After the Articles of Incorporation are filed by the Secretary of State, the incorporator chooses initial directors and calls an initial board meeting. From then on, the board of directors is the governing body. It is possible to provide for more than one incorporator; each incorporator must sign the Articles of Incorporation.

If directors are named, each must sign and acknowledge the Articles of Incorporation. These directors are the governing body of the corporation from the date that the Articles of Incorporation are filed by the Secretary of State.

Restrictive Clauses to Qualify for Tax Exemption

The clauses that must be included to qualify the corporation for California and federal charitable tax exemptions include:

- I. A clause stating that the corporation is organized and operated exclusively for charitable purposes, and shall not, except to an insubstantial degree, engage in any activities or exercise any powers that are not in furtherance of its primary charitable purposes.
- II. A clause stating that no substantial part of the activities of the corporation shall consist of carrying on propaganda, or otherwise attempting to influence legislation, and the corporation shall not participate or intervene in any political campaign on behalf of or in opposition to any candidate for public office.
- III. A clause dedicating income and assets to charitable purposes, and stating that no part of the net income or assets of the corporation shall inure to the benefit of any director, officer, member, or private person.
- IV. A clause stating that upon dissolution of the corporation, the remaining assets shall be distributed to a corporation that is organized and operated exclusively for charitable purposes and that has established its tax- exempt status under Section 501 (c)(3) of the Internal Revenue Code. This clause could provide that the assets shall be used exclusively to accomplish the primary charitable purposes for which the dissolving corporation was organized.

Filing the Articles of Incorporation

The Articles of Incorporation may be filed either by mail or in person.

To file the Articles of Incorporation by mail, submit the [Articles of Incorporation form](#)⁶ to the Sacramento office of the Secretary of State, along with a self-addressed stamped envelope, a cover letter (see sample cover letter included with the Insight Center Model Articles of Incorporation), and a check for \$30.00 made payable to the Secretary of State for the filing fee. Do not send the bylaws or exemption

⁶ <http://www.sos.ca.gov/business/corp/pdf/articles/arts-pb.pdf>

application to the Secretary of State. If the Articles of Incorporation are mailed to Sacramento, it will take approximately six weeks for its return.

Mail to:
Secretary of State
Business Entities, P.O. Box 944260
Sacramento, CA 94244-2600

To file the Articles of Incorporation in person, visit the Sacramento office or an available branch office. A \$15.00 special handling fee is charged (in addition to the \$30 filing fee), and must be remitted by separate check and will be retained whether the Articles of Incorporation are filed or rejected. Duplicate original documents must be submitted when filing with any of the branch offices. A request dropped off in person at the public counter will receive priority processing over those received by mail.

The corporation's legal existence begins on the date stamped on the Articles of Incorporation by the Secretary of State.

Certification

As of January 2013,⁷ the Secretary of State will no longer endorse and certify customer-provided copies. One uncertified copy of the Articles of Incorporation will be provided for free and may be certified for a \$5.00 fee. Additional copies will cost \$1.00 for the first page and \$0.50 for each additional page as well as an additional \$5.00 fee per copy if certification is requested. Usually, one certified copy is sufficient, since the IRS will accept a photocopy of the certified Articles of Incorporation.

The Secretary of State will forward a copy of the Articles of Incorporation to the California Attorney General once they are filed.

Preparing Bylaws

The bylaws describe the internal operations of the corporation. The incorporator or initial board of directors should prepare and adopt the bylaws for the corporation soon after filing the Articles of Incorporation. A copy of the bylaws, signed by a corporate officer or certified by the corporate secretary, must be submitted along with the federal and California tax exemption applications.

State law requires certain provisions, although most provisions are optional. The law is generally deferential to provisions stated in the Articles or bylaws, but where the bylaws are silent, state law governs.

Here are some of the most important issues to consider when drafting the bylaws:

- **Method of selecting the Board of Directors.** Board of Directors can be selected by voting members, act as a self-perpetuating body, be appointed by other organizations or persons, or by a combination of these approaches. In general, the membership form is chosen only when there is a strong reason for having members, such as increased ability to attract funds from sources that require or encourage membership, or the need to demonstrate a base of support within a community or other group of people. The increased administrative burdens of running a membership organization have led many organizations to opt not to have members.

⁷ The Secretary of State's website goes into more detail at:
www.sos.ca.gov/business/corp/pdf/amendments/corp-amdtnp.pdf

- Member provisions. If the corporation has members, then the bylaws should also consider member qualifications, method of selection, method of expulsion, dues and fees, notice of meetings and meeting frequency, the number of members required for a quorum to conduct business, and the proportion of votes required to take action on a matter.
- **Board of Directors provisions.** Consider the number of directors, qualifications for serving as a director, term of office, removal of directors and filling vacancies, notice of meetings and meeting frequency, the number of directors required for a quorum to conduct business, the proportion of votes required to take action on a matter, and the appointment of officers and committees.
- **The corporation's fiscal year.**
- **Procedures for amending the bylaws.**

If the organization is large, the most efficient way to proceed may be to form a bylaws committee. This committee then meets and discusses these issues and how the bylaws should be drafted. After the committee has approved the proposed bylaws, the bylaws may be presented to the entire organization for approval. It is important for those involved in the creation of the corporation to understand the bylaws and to feel that they were developed in a fair manner.

The Insight Center provides [two model bylaws](#):⁸ one for a nonprofit nonmembership corporation and one for a nonprofit membership corporation. A summary of membership rights is also available on the website.

Take the time to carefully consider how the corporation will operate. Consider each provision of the sample bylaws and its effect on the corporation. Consider adding, deleting, and modifying provisions to suit the corporation's needs. An attorney should prepare or review the proposed bylaws before they are adopted.

POST-INCORPORATION ACTIONS

First Board of Directors Meeting

Soon after filing the Articles of Incorporation and preparing the bylaws, the corporation should hold its first official meeting of the board of directors. A sample agenda and minutes for a first board of directors meeting indicating the types of actions that should be considered, are [available on our website](#)⁹.

Filing the Statement of Information

Following incorporation, the Secretary of State will send a Statement of Information (Form SI-100), requesting the names and addresses of the corporate officers, the address of the corporation's principal office, and the name and address of the agent for service of process. Form SI-100 can be [filed online](#)¹⁰ or submitted by mail or in-person delivery to the Secretary of State's Sacramento office. This form must be filed within 90 days after filing the initial Articles of Incorporation and submitted with the \$20 filing fee.

⁸ <http://www.insightccd.org/publications/legalpubs.html>

⁹ <http://www.insightccd.org/publications/legalpubs.html>

¹⁰ <https://businessfilings.sos.ca.gov/>

Thereafter, the Secretary of State will send the form every two years. [Further information](#)¹¹ is available from the Secretary of State.

Registering with the Attorney General Registry of Charitable Trusts

Unless otherwise exempt, every charitable public benefit corporation that holds assets (cash or other forms of property) for charitable purposes or does business in the State of California must register with the Attorney General using Form CT-1 within thirty (30) days after receipt of assets. Corporations organized primarily as a hospital, school, or religious organizations are exempt and must furnish substantiating details to the Attorney General's Registry of Charitable Trusts. The Form CT-1 must be accompanied by a \$25 check made out to the Department of Justice. Additional information is [available here](#).¹²

Annual Federal and State Filing Requirements

IRS

Most nonprofit public benefit corporations are required to file an annual information return with the IRS. The specific return to complete depends on the size of the corporation as shown in the table below:

2010 Tax Year and Later (Filed in 2011 or later)	Form to File
Annual gross receipts normally ≤ \$50,000	Form 990-N (e-Postcard) or a complete Form 990 or 990-EZ
Gross receipts < \$200,000, and Total assets < \$500,000	Form 990 or 990-EZ
Gross receipts ≥ \$200,000, or Total assets ≥ \$500,000	Form 990
Private foundation	Form 990-PF
U.S. government instrumentalities; group legal services plans; pre-1880 Armed Forces organizations; ERISA sec. 4049 trusts; Religious and apostolic organizations; Qualified tuition programs; Split-interest trusts; charitable trusts treated as private foundations	Cannot submit a Form 990-N

Form 990-N v. 990-EZ v. 990

990-N

- Known as the “e-Postcard”
- Requires only 8 items:
 1. [Employer identification number](#) (EIN),¹³ also known as a Taxpayer Identification Number (TIN).
 2. [Tax year](#)¹⁴ (usually specified in bylaws)
 3. Organization's legal name and mailing address
 4. Any other names the organization uses (Doing-Business-As names)

¹¹ http://www.sos.ca.gov/business/corp/pdf/so/corp_so100.pdf

¹² <http://ag.ca.gov/charities/>

¹³ <http://www.irs.gov/Charities-&-Non-Profits/Employer-Identification-Number>

¹⁴ <http://www.irs.gov/Charities-&-Non-Profits/Exempt-Organizations-Annual-Reporting-Requirements-Filing-Procedures:-Tax-Year>

5. Name and address of a principal officer (usually president, vice-president, secretary, or treasurer)
6. Web site address if the organization has one
7. Confirmation that the organization's annual [gross receipts](#)¹⁵ are \$50,000 or less
8. If applicable, a statement that the organization has terminated or is terminating (going out of business)

990-EZ

- 4-page form plus additional schedules

990

- 12-page form plus additional schedules

The return is due on the 15th day of the 5th month after the end of the organization's fiscal year. It cannot be filed until after the organization's tax year ends. There is no penalty assessment for late filing the Form 990-N, however an organization that fails to file the required annual return for three (3) consecutive years automatically loses its tax-exempt status. The due date for filing Form 990-EZ or 990 may be extended for up to six months in three month increments. The first extension request may be made without showing cause by filing [Form 8868](#)¹⁶ before the due date. The second extension request must show reasonable cause why the return cannot be filed by the extended due date by filing a subsequent copy of Form 8868. The Board of Directors should review the corporation's annual IRS filing before it is submitted. Additional information about the IRS' annual filing requirement can be found [here](#).¹⁷

Franchise Tax Board

Unless exempted, all nonprofit public benefit corporations are required to file an annual information return with the Franchise Tax Board. Use the following chart to determine whether to file Form 199 or FTB 199N.

		Form 199	FTB 199N
Tax year 2012 and future	Gross receipts normally equal to or less than \$50,000	No	Yes
	Gross receipts greater than \$50,000	Yes	No
Tax year 2011 and prior	Gross receipts greater than \$25,000	Yes	No
Tax year 2010 and 2011	Gross receipts normally equal to or less than \$25,000	No	Yes
Tax year 2009 and prior	Gross receipts normally equal to or less than \$25,000	No filing requirement	
Private foundations (regardless of gross receipts amount)		Yes	No
Nonexempt charitable trusts described in IRC Section 4947(a)(1)		Yes	No

¹⁵ <http://www.irs.gov/Charities-&-Non-Profits/Gross-Receipts-Defined>

¹⁶ <http://www.irs.gov/pub/irs-pdf/f8868.pdf>

¹⁷ <http://www.irs.gov/Charities-&-Non-Profits/Form-990-Series-Which-Forms-Do-Exempt-Organizations-File%3F-%28Filing-Phase-In%29>

(regardless of gross receipts amount)

You are one of the following organizations:

- Churches, interchurch organizations of local association units of a church, conventions or associations of churches, or integrated auxiliaries of churches.
- Religious orders (such as Franciscan Friars or Sisters of Charity).
- Organizations formed to carry out a function of a state, or public body that is carrying out that function and is controlled by the state or public body.
- Political organizations.
- Pension trusts.
- Coverdell Education Savings Accounts, formerly called education IRAs.
- Qualified state tuition programs.
- Subordinate organization included in the parent's group return.

No filing
requirement

"Normally less than or equal to" may mean different amounts in gross receipts depending on how old the organization is. [See this chart](#).¹⁸

The return is due on the 15th day of the 5th month after the end of the organization's fiscal year. Corporations required to file FTB Form 199 will receive an automatic 7- month extension to file a return, which does not extend the time to pay any taxes that may be due, only if the organization is not suspended on the original due date and they file their return on or before the extended due date. There is a fee for filing FTB Form 199 and penalties apply for failing to file a return, failing to furnish information, or paying the fee late. If an organization loses its tax exempt status, it must reapply using Form 3500, Exemption Application. The Board of Directors should review the corporation's annual Franchise Tax Board filing before it is submitted.

Additional information about the Franchise Tax Board's annual filing requirement can be found [here](#).¹⁹

Attorney General Registry of Charitable Trusts

Unless exempted, all nonprofit public benefit corporations are required to file an annual Registration Renewal Fee Report (Form RRF-1) with the Attorney General Registry of Charitable Trusts. Corporations with gross annual revenues of \$25,000 or more are also required to pay a [fee based on a sliding scale](#)²⁰ and file a copy of the IRS Form 990 or 990-EZ with the Attorney General Registry of Charitable Trusts.

The return is due on the 15th day of the 5th month after the end of the organization's fiscal year. Extensions of time for filing the Form RRF-1 will be allowed if an organization has received an extension

¹⁸

https://www.ftb.ca.gov/businesses/Exempt_organizations/Filing_Requirements_Form_199N.shtml#Prior_year_filing

¹⁹ https://www.ftb.ca.gov/businesses/Exempt_organizations/index.shtml

²⁰

http://oag.ca.gov/sites/all/files/agweb/pdfs/charities/charitable/rrf1_instructs_05.pdf#xml=http://search.doj.ca.gov:8004/AGSearch/isyquery/418602f3-a651-4b05-80c3-d88fa44579e3/1/hilite/

from the IRS for filing the Form 990 or 990-EZ and copies of all requests to the IRS for an extension and any approvals must be filed along with the report. The Board of Directors should review the corporation's annual Form RRF-1 filing before it is submitted. Additional information about the Attorney General Registry of Charitable Trusts annual filing requirement can be found [here](#).²¹

[The Registry of Charitable Trusts](#)²² provides a searchable database with the Form 990 and 990-EZ filed by corporations with the IRS. The corporation may withhold the identity of donors from the public, and therefore should remove the schedule listing large donors before providing Form 990 or Form 990-EZ to the Registry of Charitable Trusts.

Other Government Filing Requirements

The corporation may have to comply with other government filing requirements. The corporation should determine whether it is subject to local business license permits and/or local business taxes. Check with the local City Clerk. Charitable corporations are often exempt from payment of local business license taxes.

Sale of Goods Subject to Sales or Use Tax

If the corporation will sell goods subject to the California sales or use tax, it must obtain a Sellers Permit and Resale Certificate from the California State Board of Equalization. [Forms are available online](#).²³

Real or Personal Property Tax Exemption

For its taxable real or personal property, the corporation should apply for a property tax exemption (known as the welfare property tax exemption), if applicable. More information is [available here](#).²⁴ Check with the local County Assessor.

Employees

If the corporation will have paid employees, contact the local California Employment Development Department (EDD) office and request a copy of the "Employer's Tax Guide." Also, contact the IRS for Publication #15 (Employer's Tax Guide), the "Tax- Exempt Organizations Tax Kit," and the "Exempt Employer's Toolkit." The corporation is responsible for federal and state income tax withholding, state unemployment insurance taxes, workers compensation insurance, state disability insurance, payment of the employer's portion of federal social security (FICA), Medicare, and withholding of the employee's portion. Internal Revenue Code Section 501(c)(3) tax-exempt corporations are exempt from federal unemployment (FUTA) taxes.

Employees must complete IRS Forms W-4 and I-9 and State Form DE- 4, and the corporation must annually complete IRS Form W-2. The corporation should post the required employment notices. All IRS Forms and Publications are available online [here](#).²⁵ The Exempt Organizations Tax Kit and Exempt Employer's Toolkit can be located using the search tool on the main IRS website. Form DE-4 is available online [here](#)²⁶ and [here](#).²⁷

²¹ <http://ag.ca.gov/charities/forms.php>

²² <http://rct.doj.ca.gov/MyLicenseVerification/Search.aspx?facility=Y>

²³ <http://www.boe.ca.gov/sutax/staxformsn.htm>

²⁴ <http://www.boe.ca.gov/proptaxes/welfarevets.htm>

²⁵ <http://www.irs.gov/formspubs/>

²⁶ <http://www.edd.ca.gov/>

²⁷ <https://www.ftb.ca.gov/index.shtml?disabled=true>

For independent contractors, the corporation must file IRS Form 1099 Misc. and State Form DE-542 (for independent contractors paid \$600 or more).

If the corporation will have paid employees, prepare and adopt a personnel manual and a policies and procedures manual. In general, nonprofit corporations are subject to the same legal obligations to its employees that apply to for-profit corporations. Employers have an "implied contract" with employees in the absence of a written contract governing the terms of employment. To avoid misunderstanding, the corporation should provide each employee with a written statement of its employment practices. The corporation is also subject to minimum wage, overtime, and other laws governing terms and conditions of employment and laws prohibiting discrimination to the same extent as for-profit corporations.

Contact insurance brokers regarding bonding of employees and others who handle corporate funds, general liability and property insurance, directors' and officers' liability insurance, and employee fringe benefits such as medical insurance and retirement plans.

The corporation should maintain complete business records, including minutes of meetings, books of account, financial records and statements, and personnel records. Depending on the size and revenues of the corporation, a qualified accountant should be retained to supervise the maintenance of adequate accounting records. The corporation, even if not required by its funding sources, should consider having annual audited financial statements prepared by an independent firm of Certified Public Accountants. Pursuant to the Nonprofit Integrity Act of 2004, corporations with \$2 million or more in non-government gross revenues must undergo independent audits of their financial statements, and establish and maintain an Audit Committee.

Contact the local chapter of the American Institute of Certified Public Accountants (AICPA) or the national AICPA technical assistance unit, or the California Board of Accountancy's Clearinghouse for Volunteer Accounting Services (CVAS) for information on accountants who provide free or reduced-cost accounting services. If such assistance is not available, contact a large firm of Certified Public Accountants in your area and ask if they provide any free accounting services. Additional post-incorporation actions are included in the **Legal Compliance Checklist**.

The following is a checklist of actions for the directors to take at the first board meeting or at subsequent board meetings, as appropriate.

- ü Adopt Bylaws.
- ü Elect officers.
- ü Appoint members of committees.
- ü Authorize purchase of corporate record books.
- ü Fix the location of the principal office.
- ü Apply for a corporate Employer Identification Number.
- ü Select a bank or banks and authorize the opening of an account or accounts.
- ü Authorize check signers.
- ü Authorize payment or reimbursement of incorporation and filing expenses.

- Ü Authorize the filing of federal and state income tax exemption applications.
- Ü Appoint a registered agent for service of process.
- Ü Authorize the filing of the Statement of Information.
- Ü Authorize the filing for any necessary local business license and payment of any applicable local city tax.
- Ü Select an insurance broker or brokers and authorize the purchase of general liability and property insurance, bonding, directors and officers' liability insurance, and employee fringe benefits such as medical insurance and retirement plans.
- Ü Select an accountant or auditor, and select an attorney.
- Ü Authorize the application for a seller's permit and resale certificate if selling goods subject to sales tax.
- Ü Authorize the application for a welfare property tax exemption if own or lease property subject to property tax.
- Ü Authorize obtaining a nonprofit mailing permit to use special bulk third-class postal rates.
- Ü Approve the following contracts and authorize their execution:
 - Office space or building lease.
 - Contracts for accounting and legal services.
 - Engagement letter or employment contract with the Executive Director, including the amount of compensation.
 - Agreements to transfer prior funding and obligations to the corporation.
 - Contracts with other parties in furtherance of the corporation's charitable activities.
- Ü If the corporation has employees, attend to the following personnel matters:
 - Obtain the necessary forms and information from the IRS and California EDD for income tax and FICA withholding, state disability insurance, unemployment, and workers compensation.
 - Have employees complete the IRS Forms W-4 and I-9 and State Form DE-4.
 - Post the required employment notices.
 - Adopt a personnel manual and a policies and procedures manual.
- Ü Adopt conflict of interest, whistleblower, and document retention and destruction policies.

OBTAINING TAX EXEMPT STATUS

Advantages

The advantages of obtaining charitable, Internal Revenue Code (IRC) Section 501(c)(3) tax-exempt status are:

1. Exemption from federal and state income tax on earned and investment income, except net income from activities unrelated to tax exempt purposes, or investment income from assets acquired with debt. This exemption is also available under other subsections of IRC Section 501(c).
2. Only organizations with this exemption qualify for charitable tax-deductible contributions from individuals or others, and many grants from government, foundations, and corporations are limited to 501(c)(3) organizations. Tax- exempt organizations can also purchase property through a bargain sale, in which the organization purchases the property at less than fair market value, and the seller receives a tax deduction for the difference between the property's value and the sales price.
3. Exemption from other taxes:
 - a. FUTA (federal unemployment tax).
 - b. State property tax (with limitations).
 - c. State sales and use tax (very limited).
 - d. Local business license tax (in most places).
 - e. Not exempt from FICA or state unemployment tax, although can opt out of state unemployment system and self-insure alone or through pool of 501(c)(3) organizations.
4. Reduced bulk third-class mail rates.
5. Enhanced perception from within the community.

Disadvantages

The disadvantages of obtaining charitable, Internal Revenue Code (IRC) Section 501(c)(3) tax-exempt status are:

1. Corporate activities are limited to those which further 501 (c)(3) purposes, except to an insubstantial degree.
2. Limits on lobbying and political activity.
 - a. No substantial lobbying (attempting to influence legislation).
 - i. "Substantial" is not defined in the tax code or regulations but is generally considered to be greater than 5% of organization's activities or expenditures.
 - ii. An organization can elect to come under a strict numerical test of approximately 20% of expenditures (of which 25% can be grass roots lobbying), under IRC Section 501(h) by filing form 5768

- iii. First determine whether activity is lobbying - for example, nonpartisan analysis or discussion of issues is not lobbying.
 - iv. Individuals on their own time are not limited.
 - v. Can form IRC Section 501(c)(4) organization for more lobbying.
- b. No political activity on behalf of or in opposition to any candidate for public office.
- i. Can sponsor neutral forums (educational).
 - ii. Individuals on their own time are not limited.
3. Limits on distribution of assets
- a. On dissolution, after payment of debts, assets must be distributed to another 501(c)(3) organization.
4. Cannot unduly benefit private individuals.
- a. No dividends; net earnings cannot inure to benefit of directors, officers, members, or others.
 - b. No excessive salaries or buying property at more than fair market value.
 - c. Can make reasonable payments, including reasonable fees to directors.
5. Greater scrutiny by IRS, Franchise Tax Board, and California Attorney General, to insure that assets are used for 501(c)(3) purposes, plus funding source scrutiny and public inspection rights, and detailed record keeping and reporting requirements.

Generally, for most charitable nonprofit corporations, the benefits of obtaining income tax exemption (ability to attract certain funding and exemption from corporate income tax) outweigh the disadvantages.

Process

The process of obtaining federal and California income tax exemption is separate from the process of incorporating. A discussion of the mechanics of obtaining a federal tax exemption under Section 501(c)(3) of the Internal Revenue Code, along with a completed sample tax exemption application (IRS Form 1023) are available [on the website](#).²⁸ An organization that obtains recognition of exemption under Section 501(c)(3) from the IRS need only submit to the FTB a copy of its determination letter with the brief form 3500A as a cover.

To qualify for Section 501(c)(3) tax-exempt status, the corporation must be organized for charitable (and/or educational) purposes.

"Organized" means that the purposes specified in the Articles of Incorporation must be limited to charitable/educational purposes, and that the Articles of Incorporation must contain the restrictive clauses described previously. Also, the corporation must be operated exclusively (primarily) for charitable/educational purposes.

Charitable purposes include the following:

²⁸ [http://www.insightcced.org/uploads/publications/legal/Ch7_sample tax exemption.pdf](http://www.insightcced.org/uploads/publications/legal/Ch7_sample%20tax%20exemption.pdf)

1. Relief of the poor, distressed, or underprivileged (a "charitable class" of low- income, minority, elderly, disabled, other 501(c)(3) organizations, etc.).
 - a. No uniform definition of poor.
 - b. Some non-needy individuals may benefit from activities whose primary purpose is to aid the needy, no uniform limit or percentage of non-needy that may benefit.
 - c. Examples:
 - i. Assistance in securing employment, such as vocational training, or establishing a market for their products. **Rev. Rul. 76-37, 1976-1 CB 148; Rev. Rul. 68-167, 1968-1 CB 255.**
 - ii. Assistance in maintaining employment, such as operation of a child care center or a counseling and referral center. **IRC Section 501 (k), Rev. Rul. 66-257, 1966-2 CB 212.**
 - iii. Financial and technical assistance to businesses owned wither by the needy or by others who employ the needy. **Rev. Rul. 74-587, 1974-2 CB 162; Rev. Rul. 81-284, 1981-2 CB 130.**
 - iv. Provision of housing, legal services, meals, transportation, and other services to the needy, **e.g. Rev. Rul. 78-428, 1978-2 CB 177.**
2. Lessening the burdens of government.
 - a. Supplying the community with facilities or services ordinarily provided at government or government provides funding.
 - b. Requires objective manifestation by government that it considers the activity to be in burden; not enough that the activity is sometimes done by government or government provides funding.
 - c. Examples:
 - i. Provision of recycling services. **Rev. Rul. 72-560, 1972-2 CB 248.**
 - ii. Developing a community land use analysis and plan. **Rev. Rul. 67- 391, 1967-2 CB 190.**
 - iii. Providing /maintaining recreational facilities and public parks. **Rev. Rul. 78-85, 1978-1 CB 190.**
3. Promotion of social welfare by lessening neighborhood tensions, eliminating prejudice and discrimination, defending human and civil rights, and combating community deterioration and juvenile delinquency.
 - a. Categories overlap with each other and sometimes with relief or poor, however, although beneficiaries are often poor, they need not be.
 - b. Benefits to community in general, for example, when services are provided to minorities, women, immigrants, or other persons denied equal treatment because of race, gender, citizenship, or other protected status.

- c. Can attack the physical, economic, and social causes of deterioration, etc., but not all improvement activity qualifies.
- d. Examples:
 - i. Purchasing and renovating deteriorating residences and selling or renting to needy families at affordable rates. Rev. Proc. 96-32, 1996-1 CB717.
 - ii. Lending to businesses willing to locate in a blighted community but unable to obtain conventional financing because of the risks associated with the location. Rev. Rul. 74-587, 1974-2 CB 162.
- 4. Developing commercial or industrial space in the community and renting to businesses that agree to train and employ unemployed area residents. **Rev. Rul. 76-419, 1976-2 CB 146.**
- 5. Promotion of health.
- 6. Advancement of education, such as through instruction or training to improve or develop individual capabilities, or instruction on subjects useful to the individual and beneficial to the community.

Activities that are **not charitable** include the following:

- 1. Operating low-cost grocery or pharmacy stores, despite the need in the community for such services. **Senior Citizens Stores, 602 F2d 711 (5th Cir. 1979); Rev. Rul. 73-127, 1973-1 CB 221; Federation Pharmacy Services, 80-2 USTC U 9553 (8th Cir. 1980).**
- 2. Assisting businesses through area-wide efforts to revive retail sales, when assistance is not limited to businesses experiencing difficulty in obtaining conventional assistance because of the area or their minority composition, or businesses that agree to locate or remain in the area and provide training and employment to unemployed residents. **Rev. Rul. 77-111, 1977-1 CB 144.**

Business Activities

Although charitable activities are often performed under grants at no/low charge to beneficiaries (less than cost), business activities can be charitable even if they do generate profits. The primary purpose of the business activity must be charitable ("related business activity"), not income generation ("unrelated business activity").

- 1. A business is an income-generating activity regularly carried on.
 - a. Distinguish from fundraising (not regularly carried on).
 - b. Distinguish from noncommercial activity: use of volunteers, sale of donated goods, convenience of employees, bingo.
- 2. To be charitable, a business must be done as a means to achieve a charitable purpose. Considerations:
 - a. How the income is earned, not at how the surplus will be used.
 - b. The nature and size of business; is it on scale consistent with a charitable purpose (affordable, below cost?)

- c. Who is served (charitable class)?
 - d. Does it operate in typical commercial manner competing with private business?
3. Examples of related businesses include:
- a. Job training program in which trainees manufacture an item sold for profit. **Industrial Aid for the Blind, 73 T.C. 96 (1979); Rev. Rul. 76-94, 1976-1 CB 171; IRS Ltr. Rul. 9641011 (6/28/96).**
 - b. Investing in businesses in a distressed community that could not obtain conventional financing due to discrimination or location. **Rev. Rul. 74- 587, 1974-2 CB 162.**
4. Examples of unrelated businesses include:
- a. Providing services to other 501(c)(3) organizations at cost. **Rev. Rul. 72- 369, 1972-2 CB 245.**
 - b. Providing property management services for low-income housing owned by a city for a standard commercial fee. **Inter-neighborhood Housing Corp., TC Memo 1982-661, 45 TCM 115 (1982).**
5. An activity that is part grant-supported and part income-supported (for example, a sliding fee scale, in which fees are based on a person's ability to pay) has been held charitable. The income received from those able to pay more than cost is used directly to subsidize those who pay less than cost, with grants making up the shortfall.

Residential Real Estate Activities

Residential real estate activities can be charitable when (**Rev. Proc. 96-32**):

1. Relief of the poor and distressed: safe harbor rule.
 - a. At least 75% of the units in a project must be occupied and affordable for earning 80% or less of area median income; of these, either at least 20% of the units must be occupied and affordable for families earning 50% or less of area median income, or 40% of the units occupied and affordable for families earning 60% or less of area median income.
 - b. Remaining units may be provided at market rates.
2. Relief of the poor and distressed facts and circumstances test.
 - a. Look at percentage of low and very-low income, with higher-than-required percentage of very low-income and limited deviation from safe harbor for low-income.
 - b. Evidence that persons aided could not otherwise secure housing so are similar to low-income persons, such as due to unusually high medical expenses.
 - c. Participation in a government housing program designed to provide affordable housing.
 - d. Provision of additional social services.
 - e. A community-based board of directors and community input into operations.
3. Combating community deterioration.

- a. Rehabilitation or new construction in an area designated by government as blighted, as long as designation demonstrates deterioration.
 - b. Rehabilitation or new construction in an area in which facts and circumstances demonstrate blight, such as studies showing the area is old and deteriorated and has a lower median income than rest of the city, has high unemployment, has limited recreational facilities, has declining property values, has high percentage of abandoned or vacant structures, has high crime/drugs or graffiti, and many homes below code.
 - c. Area need not already be deteriorated, may be in process of deterioration, or organization's activities may stabilize area to combat the potential for deterioration.
4. Lessening neighborhood tensions, eliminating prejudice and discrimination by developing housing for members of minority groups unable to obtain adequate housing because of discrimination.
 5. Providing specialized housing for the elderly or handicapped.

Commercial Real Estate Activities

Commercial real estate activities can be charitable when:

1. Office space is for own organization use.
2. Rent to other 501 (c)(3) organizations, if charging lowest feasible rent. **Rev. Rul. 69-572, 1969-2 CB 119.**
3. Rent to businesses owned by poor or minorities, especially in blighted areas, when owners would have difficulty finding other suitable space in area. **Rev. Rul. 74-587, 1974-2 CB 162.**
4. Rent to businesses with lease provisions requiring job training and employment of disadvantaged area residents; **Rev. Rul. 76-419, 1976-2 CB 146.**
5. Use rent to make grants to other 501 (c)(3) organizations or reduce the rent of other 501(c)(3) tenants. **Rev. Rul. 64-182, 1964-1 CB 186; Rev. Rul. 69-572, 1969-2 CB 119.**

Non-Charitable Activity

A charitable corporation can engage in a limited amount of non-charitable (unrelated business) activity and still qualify for 501(c)(3) status.

1. Usually not more than 15% of income or effort can be non-charitable.
2. Net income from unrelated activity is subject to tax; include all costs in calculation.
 - a. Exception from tax for passive income such as real property rents, interest dividends, royalties, and capital gains. IRC § 512(b).
 - b. Exception is lost, and thus net income is taxed, to the extent that the activity is financed with debt. IRC §§ 512(b)(4) and 514.
3. If too much non-charitable activity, will lose or not receive 501(c)(3) status; move activity to for-profit subsidiary.

- a. Other reasons for forming subsidiary include liability protection, funding source requirements, and management capacity.
 - b. Retain control of subsidiary through selection of its directors.
 - c. Funds can be transferred back to the 501 (c)(3) through a contract for services or as after-tax dividends.
4. A single activity can be part-related, part-unrelated to charitable purposes.

LEGAL COMPLIANCE CHECKLIST

The corporation should regularly assess its compliance with legal formalities.

Common Pitfalls

1. Self-dealing transactions either between a director and the public benefit corporation, or by trustees;
2. Loans by a corporation to a director or officer;
3. Loss of substantial corporate funds or assets during one year;
4. Losses of charitable assets through speculative investments;
5. Excessive amounts paid by a public benefit corporation or charitable trust for salaries, benefits, travel, entertainment, legal and other professional fees;
6. Sale of a charity or conversion of a public benefit corporation to for-profit status (authorized by statute under restricted conditions) at a price that is unfair to the charity;
7. Illegal use of charitable funds; and
8. Diversion of charitable funds from their intended purpose.

Monitoring

1. The corporation furnishes each director and officer with a written list of all federal and California legal filing and reporting requirements.
2. The corporation has assigned to appropriate directors and staff the responsibility for meeting all filing and reporting requirements.
3. The board or a board committee regularly determines that all filing and reporting requirements have been met in a timely manner, or that appropriate and timely corrective action has been taken.

Personnel

1. The corporation has applied for and been assigned a federal employer identification number by the Internal Revenue Service (IRS).
2. The corporation has registered with the California Employment Development Department (EDD) and secured an EDD account number.

3. The corporation withholds federal and state income taxes and federal social security (FICA) taxes from taxable wages paid to employees, pay the employer share of FICA taxes, and deposits all such funds in a timely manner and with the appropriate IRS and EDD forms.
4. The corporation withholds state disability insurance from taxable wages paid to employees, and deposits all such funds in a timely manner with EDD, or establishes a state -approved private disability insurance plan.
5. The corporation purchases workers' compensation insurance through an authorized insurance company or from the State, or secures consent to self-insure. The Board of Directors has declared that the corporation's volunteers are employees for workers' compensation purposes, and the corporation has so notified its insurance carrier.
6. The corporation pays state unemployment insurance or elects the reimbursement method.
7. The corporation pays any local city-imposed payroll tax.
8. The corporation obtains a completed federal Form 1-9 from all new employees.
9. The corporation reports all newly hired employees to the EDD.
10. The corporation notifies employees about the Earned Income Credit.
11. The corporation obtains a completed IRS Form W-4 and state Form DE-4 from each employee.
12. The corporation furnishes each employee with a completed IRS Form W- 2 by January 31 for the previous calendar year.
13. The corporation posts or provides to its employees the required employment notices.
14. The corporation complies with wage and hours laws, workplace safety laws, and nondiscrimination laws.
15. The corporation complies with its employee benefit plan requirements.
16. The corporation complies with its written personnel policies and procedures.
17. The corporation prepares proper documentation of all independent contractor arrangements, and reports compensation to independent contractors on IRS Form 1099 MISC.

Annual Income Tax and Financial Filings and Reports

1. The corporation files annual tax information returns (IRS Form 990, 990- EZ or 990-N and Franchise Tax Board (FTB) Form 199 or 199N). If the corporation has unrelated business income, it files IRS Form 990-T and FTB Form 109.
2. The corporation files the bi-annual Statement of Information (Form SI-100) with the California Secretary of State (filing fee \$20).
3. The corporation files Form RRF-1 annually with the California Attorney General (AG) Registry of Charitable Trusts (filing fee on a sliding scale, for companies with more than \$25,000 of gross annual revenue), and files the IRS Form 990 or 990-EZ with the Registry.

4. The corporation sends an annual report to its directors and members, if any, within 120 days after the close of its fiscal year with the required financial information and an accountant's report, if prepared.

Other Filings and Reports

1. The corporation has applied for and maintained a property tax exemption with the county assessor.
2. The corporation has obtained a sellers permit to sell property subject to the state sales and use tax, and remits all collected sales and use taxes in a timely manner.
3. The corporation has obtained a local city business license if required.
4. The corporation has obtained other federal, state, or local licenses as required for its activities.
5. The corporation has obtained a nonprofit mailing permit to use special bulk third-class postal rates.
6. The corporation has filed amendments to its Articles of Incorporation (after certification by the California Secretary of State) and its Bylaws with the IRS, FTB, and AG.
7. The corporation makes appropriate filings to protect its intellectual property (trademarks and service marks, copyrights and patents).
8. The corporation makes appropriate filings to comply with lobbying registration, disclosure, and reporting requirements.
9. The corporation makes annual benefit plan filings (IRS Form 5500) as required.

Liability Protection

1. The corporation maintains appropriate commercial general liability insurance, with reasonable exclusions and limitations.
2. The corporation maintains appropriate bonding for those persons who handle its funds, with reasonable exclusions and limitations.
3. The corporation maintains appropriate errors and omissions or other professional liability insurance, with reasonable exclusions and limitations.
4. The corporation maintains appropriate directors' and officers' liability insurance, with reasonable exclusions and limitations, or annually reviews the affordability of such insurance.

Other Requirements for Tax Exempt Organizations

1. The corporation engages legal counsel to conduct an annual review of its past year's operations and coming year's proposed operations, to identify conflicts and inconsistencies with the information previously provided to the IRS and FTB, and for an opinion on whether the corporation is or will be engaged in unrelated business activity.
2. The corporation complies with disclosure, substantiation, and reporting requirements for contributions received.
3. The corporation observes the prohibition on political campaign activities.

4. The corporation conducts an annual review to determine its compliance with public charity status requirements, including the avoidance of excess benefit transactions and reports its public support information on Form 990 or 990-EZ.
5. The corporation observes the limitations on its lobbying activities, and maintains appropriate records to document its lobbying expenditures and activities.
6. The corporation requires directors, officers and key employees to review and acknowledge its conflict of interest policy on an annual basis.
7. The corporation conducts a periodic review of compensation arrangements and partnerships, joint ventures, and other transactions to ensure that they conform to the organization's policies and reflect an exchange of reasonable payment or compensation for services or benefits to the organization.
8. The corporation establishes processes for collecting information on business relationships between current and former directors, officers, key employees and the corporation, and business and family relationships among current and former directors officers, key employees.

Operations

1. The corporation has selected a bank after comparing and negotiating rates and fees. The corporation has authorized at least two persons as check signers.
2. The corporation appropriately invests its assets that are held for investment.
3. The corporation maintains an up-to-date copy of its Articles of Incorporation and Bylaws at its principal office.
4. The corporation maintains adequate and correct books and records of account.
5. The corporation prepares and maintains minutes of board, committee, and member meetings.
6. The corporation maintains copies of notices of board and member meetings, written waivers of notice, consents to the holding of meetings, approvals of minutes, and unanimous written consents for board and member meetings. The corporation maintains copies of written director and officer resignations, written member ballots and proxies, and similar documents.
7. The corporation maintains an alphabetized list of members (if any), with name, address, and class of membership.
8. The corporation makes available for public inspection a copy of its federal tax exemption application, IRS tax exemption determination letter, and IRS Form 990 for the previous three years, and provides a copy on request.
9. The corporation complies with its Bylaws, including the provisions on term of office of directors, election of officers, and obtaining member approval for certain actions. The corporation holds all meetings it is required to hold, and collects all required member dues.
10. The corporation complies with the state and local charitable solicitation laws and ordinances.

Transactions

1. The corporation conducts appropriate investigations to ascertain that loans, leases, and other transactions are at fair market value or are favorable to the corporation.
2. The corporation complies with securities laws by registering or securing an exemption from registration for its debt instruments.
3. The corporation prepares appropriate documentation in support of all transactions with directors, officers, or other insiders, and to demonstrate the reasonableness of all compensation. The corporation meets all requirements for approval of self-dealing transactions or transactions with corporations that have interlocking directorships with the corporation (including corporations under its control).
4. The corporation engages legal counsel to review proposed contracts and agreements to identify issues of liability not already handled by insurance, corporate obligations to perform acts that might jeopardize its tax exempt status, and whether there are appropriate safeguards to assure that corporate funds granted to other organizations are being used for tax exempt purposes.
5. The corporation receives the benefits of, and meets its obligations under, all leases, loans, contracts, partnerships, joint ventures, or similar agreements.
6. If the corporation controls any subsidiary nonprofit or for-profit corporations, it monitors their performance and their compliance with all corporate formalities.