

HOW TO FORM A NONPROFIT CORPORATION

A corporation is a distinct legal entity under California law. A new corporation is "born" when its Articles of Incorporation are filed with the Secretary of State. The basic steps and minimum requirements for forming a public benefit corporation are summarized in this chapter.

Preliminary Considerations: Do You Really Want to Create a Charity?

Although public benefit corporations may qualify for many important benefits, including income tax exempt status, they are also subject to important legal restrictions. One very critical restriction is that the assets of a public benefit are irrevocably dedicated to charitable purposes, and cannot be distributed for private gain. If the organizers of a public benefit corporation later decide that they do not wish to operate the corporation as a charity, they may terminate the public benefit corporation but they cannot take back its assets. Legally, those assets belong to charity, and must be transferred to another charity that has similar purposes.

It is important to consider carefully the goals of the new organization before taking any steps to form a public benefit corporation. There are many factors to consider before choosing the legal form for the organization and evaluating whether the advantages of income tax exempt status outweigh the legal restrictions on public benefit corporations. Some important factors to review are: (1) What are the purposes of the new organization? (2) What are the projected income needs and sources of income? (3) What are the tax considerations? (4) How do you plan to distribute "surplus" income? (5) How do the standards of liability for directors vary between nonprofit and for-profit corporations, as compared to trusts and unincorporated associations? (6) What are the goals and interests of members of the organization? (7) How much flexibility of operation is desired? (8) What are the government regulations on nonprofit corporations as compared to for-profit business corporations?

APPLICATION FOR TAX EXEMPT STATUS

Most charitable organizations in California seek income tax exempt status under federal Internal Revenue Code (IRC) section 501(c)(3) and California Revenue and Taxation Code section 23701(d). These provisions generally exempt a charity from federal or state income tax on all forms of income derived from the charity's exempt purposes. Individuals who itemize and corporate donors may deduct contributions to "section 501(c)(3) organizations," subject to various limitations set forth in IRC section 170.

What is 501(c)(3) Status?

A section 501(c)(3) organization must be "organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary or educational purposes." To qualify, an organization must satisfy an organizational test and an operational test. The organizational test is met if the articles of incorporation include language limiting the purposes of the organization to one or more of the exempt purposes set forth in section 501(c)(3) and do not empower the organization to engage in any substantial activities which do not further one or more exempt purposes. In addition, the organizational documents (or applicable state law) must require the organization to expressly dedicate its assets to exempt purposes in the event of a dissolution.

The operational test requires the organization to be engaged primarily in activities which accomplish one or more of the exempt purposes specified in section 501(c)(3). The test will not be met if "more than an insubstantial part" of the organization's activities is not in furtherance of exempt purposes. Examples of impermissible conduct include inurement of net earnings to private individuals and engaging in certain prohibited political activities, such as substantial lobbying or participation in political campaigns on behalf of or in opposition to candidates for public office. Nonprofit California public benefit corporations also may be required to show that no more than 49 percent of the organization's directors are "interested persons" or their close relatives, as defined in

California Corporations Code section 5227- (See Chapter 6 for discussion of "interested" directors.)

'Public Charity' or 'Private Foundation'?

Organizations that qualify for exemption under IRC section 501(c)(3) will be classified by the IRS as either a public charity or a private foundation. Most organizations (with a few exceptions, such as churches) are presumed to be private foundations unless they receive a determination from the IRS that they are a "public charity". In general, an organization will be classified as a public charity if it receives a certain percentage of its total support from government sources, other public charities or a broad base of individual donors. An organization also may avoid being classified as a private foundation if it maintains a support relationship with one or more public charities or governmental entities; this relationship may be either financial or programmatic.

Classification as a private foundation carries with it several disadvantages, including a 2 percent excise tax on the organization's net investment income, certain limitations on the deductibility of charitable contributions by individual donors, a wide range of operational requirements and restrictions and more burdensome reporting requirements.

Unrelated Business Income Is Taxed

Regardless of their private foundation classification, section 501(c)(3) organizations are subject to tax on income derived from actively conducted business activities that are substantially unrelated to the organization's exempt purposes.

How To File For Income Tax Exempt Status

An organization that wishes to obtain income tax exempt status must file applications with the appropriate federal and state authorities. Obtaining a federal tax exemption under IRC section 501(c)(3) requires the submission to the IRS of Form 1023 (Application for Recognition of Exemption under Section 501(c)(3).) The application generally must be filed within 15 months from the end of the month of incorporation. Income tax exempt status, if granted by the IRC, will be retroactive to the date of incorporation. Under recently enacted legislation, an organization filing an initial application for income tax exempt status also must pay a fee ranging from \$150 to \$300. A similar procedure requires the submission to the California Franchise Tax Board of Form 3500 to obtain tax-exempt status in California. More information on the criteria and procedures for applying for

Basic Steps for Incorporation
Of A Public Benefit Corporation

A nonprofit public benefit corporation may be formed by following the basic steps for creating a California nonprofit corporation, which are summarized below.

1. Choose a corporate name: You may clear and reserve the corporate name by calling the Secretary of State. After clearing the corporate name, you must send a check to the Secretary of State's office to reserve the name. For additional information contact the Secretary of State's office. See the "Directory of Services" for listings.
2. Draft ARTICLES OF INCORPORATION and file the articles (two copies for public benefit corporations) with the Secretary of State. The Articles of Incorporation must state the name of the public benefit corporation, its purpose, and that it is not organized for the private gain of any person. (For forms of Articles of Incorporation, see the "Bibliography" listings.)
3. Draft the BYLAWS of the corporation. Bylaws set out the basic rules for operating the corporation. These rules may be limited by California laws and are very important to the governance of the corporation. (See "Bibliography" for assistance on drafting bylaws.)
4. File APPLICATION FOR INCOME TAX EXEMPT STATUS with IRS (Form 1023) and California Franchise Tax Board (Form 3500). (See Chapter 3 of this Guide.)
5. File federal APPLICATION FOR EMPLOYER IDENTIFICATION NUMBER (Form SS-4) with the IRS.
6. File an annual STATEMENT BY DOMESTIC NONPROFIT CORPORATION which will be sent to you by the Secretary of State after you have filed your Articles of Incorporation. This filing designates an agent for service of process.
7. Hold first meeting of directors. Agenda items for the first meeting usually include adopting bylaws, electing officers, establishing a bank account, setting the accounting year and basic accounting procedures, planning a budget for the first year, and procedures for

federal tax exemption can be found in IRS Publication 557 (How to Apply for and Retain Exempt Status for Your Organization).

In general, IRS Form 1023 requires the organization to submit the following documents: (1) a conformed copy of the organization's articles of incorporation (or trust instrument); (2) the bylaws (if a nonprofit corporation); (3) the Employer Identification Number of the organization or an application therefor on Form SS-4; (4) a statement of receipts and disbursements; (5) a current balance sheet; (6) other financial information, including a proposed budget for two years in the case of newly formed organizations; and (7) an executed copy of a consent to extend the period in which to assess tax (Form 872-C).

Federal laws enacted in 1988 require all tax exempt organizations to make available for public inspection at their offices during regular business hours a copy of the three most recent annual information returns (Form 990 or 990-PF for IRC 501(c)(3) organizations), exemption applications and determination letters.

Property Tax Exemption

The California State Board of Equalization, together with county assessors, are the administrators of the welfare exemption from property taxation (Cal. Rev. & Tax Code, § 214 et seq.). There are many requirements for obtaining a welfare exemption from property taxes, and income tax exempt status is only one of them. For further information, see the listing for State Board of Equalization in the "Directory of Services."

Sales Tax Exemption

A charity that sells items may be required to collect and remit to the state sales tax on goods sold. The rules for sales tax exemption are different from the rules for income tax exempt status. The exemption for sales tax related to the charitable purpose is subject to many regulations. For further information, see the listing for State Board of Equalization in the "Directory of Services."

Other Types Of Tax Exemption

Section 501(c)(3) organizations also may be exempt from property taxes and certain federal excise taxes. They generally are not exempt from sales and use taxes or employment taxes.

The law of tax exempt organizations is highly complex, and this discussion is intended only as a broad overview of the requirements for exemption. Organizations with special problems

safekeeping of minutes, bylaws and other corporate records. It is important for the corporate secretary to record and keep minutes of all meetings of the board of directors.

8. Review the corporation's need for state and local permits and licenses, and for registration with the Attorney General's Registry of Charitable Trusts, plan to meet deadlines for required annual filings with IRS, Franchise Tax Board, Attorney General. (See Chapters 3, 10 of this Guide.)

There are several books and government publications that discuss in more detail the steps for forming a nonprofit corporation. See the "Bibliography" for listings.

This Guide and the publications cited in the "Bibliography" are not a substitute for professional legal assistance. You may wish to seek the professional legal services of an attorney and/or tax expert in forming a new nonprofit corporation.

FREQUENT QUESTIONS

Q. Is it necessary to hire an attorney to form a public benefit corporation?

A. No. California law does not require that you retain an attorney to form a corporation. However, as noted earlier, there are many questions to review prior to deciding to form a public benefit corporation: An attorney who specializes in the area of nonprofit corporations could assist in such review and guide the organizers through steps of incorporation and application for income tax exempt status.

Many charitable organizations cannot afford to pay the fees charged by private attorneys. There are low cost or free legal services available to certain types of charities in some areas. Consult the "Directory of Services" for listings.

Q. What is the simplest legal form to use in creating a charity?

A. The public benefit corporation is the recommended legal form for most California charities (except religious organizations). Although there is significant paper work involved in forming a public benefit corporation, the procedures for operation and the rights and duties of directors, officers and members of public benefit corporations are more clearly set forth under California law than for other forms of organization.

or that need more assistance should consult the listings in this Guide under "Directory of Services" and "Bibliography", or a private attorney or tax expert.

FREQUENT QUESTIONS

Q. How long does it take to find out if our organization will receive federal income tax exempt status from IRS?

A. Generally, it takes at least three months after filing the application for income tax exempt status (Form 1023) with IRS to learn if the application has been granted. When IRS notifies you of the decision to grant federal income tax exempt status, IRS will include instructions for annual filing of IRS Form 990 or 990-PF which is required to maintain federal income tax exempt status. (See "Directory of Services" for IRS listings.)

Q. If IRS denies the application by our organization for income tax exempt status, what can we do with the funds already donated to the organization?

A. In most cases, all funds collected by a charitable organization are irrevocably dedicated to charitable purposes. Even if the organization fails to receive income tax exempt status from IRS, the funds must be used for charitable purposes, and cannot be refunded to the donors.

In special circumstances where an organization was formed as a public benefit corporation by mistake, where its organizers intended it to be a mutual benefit corporation, and where all the funds received were dues from members, the organization may be allowed to terminate as a charity and refund the dues and other assets to members, rather than to charity. However, the Attorney General's written consent must be obtained if the organization was formed as a public benefit corporation.

Q. What are the procedures for obtaining state income tax exempt status for our organization?

A. The procedures for obtaining California income tax exempt status from the California Franchise Tax Board are similar to those for IRS. California FTB Form 3500 must be completed and submitted to FTB. The FTB will notify the applicant of its decision on exempt status, and also send instructions for annual filing of FTB Form 199. (See "Directory of Services" for FTB listing.)

This may be very helpful during the operating life of the corporation.

Q. How does our charitable organization obtain "tax exempt status?"

A. To obtain federal income tax exempt status for a charitable organization, it is necessary to apply to the IRS for classification as a "501(c)(3)" organization under the Internal Revenue Code.. Most California charities also apply to the California Franchise Tax Board for California income tax exempt status. The basic steps and the necessary application forms are described in Chapter 3 of this Guide. There are free publications available from the IRS and Franchise Tax Board that include instructions on applying for tax exempt status. See the "Directory of Services" and "Bibliography" in this Guide for listings.

Q. How do we register our charitable organization with the Attorney General?

A. Registration of public benefit corporations is now done automatically when the Attorney General's Registry of Charitable Trusts receives from the Secretary of State the duplicate filed copy of articles of incorporation. The Registry will mail to each new public benefit corporation instructions for filing the annual CT-2 report (which includes the IRS Form 990) with the Attorney General. The new public benefit corporation has up to one and one-half years after it receives assets before its first CT-2 report is due.

Charities that are not public benefit corporations will not be registered automatically by the Registry. These charities must write to the Registry to obtain registration forms and other instructions. (See "Directory of Services" for Attorney General's Registry listing.)

Q. Our charitable organization has special tax problems. Where can we find an expert on charitable tax exempt organizations?

A. The law on charitable tax exempt organizations is very complex and quite specialized. Be certain if you hire a tax attorney or other tax expert that the person is knowledgeable about this area of tax law. You may contact any of the following for tax expert referrals. Be sure to specify the area of expertise that your organization seeks.

- The County Bar Association referral service in your area.
- Accredited law schools in your area will usually have a tax specialist on their faculty. The tax professor may be able to refer you to an attorney who specializes in tax exempt organizations.
- Large charitable organizations in your area may be able to give you names of tax experts who have assisted their organization.

Q. If our charity is granted federal and state income tax exempt status, does the charity have to pay property tax on property it owns? Does the charity have to pay sales tax on items it sells?

A. A charity with income tax status may still have to pay property tax and sales tax. The rules that apply to exemption from property and sales taxes are different from the rules for income tax exempt status. Contact the State Board of Equalization and the local county assessor's office for additional information. (See the "Directory of Services" listings.)