

**WHAT AN ATTORNEY SHOULD KNOW
BEFORE ORGANIZING A NONPROFIT CORPORATION**

Presented by

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1. CONSIDER AN *EXISTING* ORGANIZATION AS AN ALTERNATIVE TO CREATING A *NEW* ORGANIZATION

- 1.1 Use as resources local community foundations and the funding library at the Center for Nonprofit Management in Southern California.
- 1.2 Avoid the cost, hassle, education and diversion of energy to the organization and tax exemption process

2. TYPE OF ORGANIZATION

2.1 Trust –

OK for private foundation, not for an active organization.

For private foundation, must include prohibitions on prohibited transactions

Consider liabilities of trustees

Can provide clear succession path for trustees

Most sensible investment standards for trustees

¹ *This outline should be viewed only as a summary of the law and not as a substitute for tax or legal consultation in a particular case. Your comments and questions are welcome.*

2.2 Association –

No liabilities limits for managers, but easy to organize. Must have bylaws.

If you are going to apply for tax exemptions, it is just about as much time and hassle to organize a nonprofit corporation, which is a lot better form of organization for an active organization.

2.3 Nonprofit corporation –

Liabilities limits for managers are most clear.

California has a good nonprofit corporation law.

A corporation is easy for others to deal with, so best for an active organization.

Duties of directors and officers are reasonable and similar to for profit corporations

⇒ Exception – investment standard for California nonprofit public benefit corporation is to preserve principal, not modern portfolio theory (which applies for trusts)

3. STATE OF ORGANIZATION

3.1 For California-based organization, use California law.

⇒ Issue – Interested directors rule. No more than 49% of the directors can be paid by the corporation (excluding director fees) or related to someone who will be paid by the corporation.

3.2 If based in several states, consider a Delaware nonstock corporation

Remember to register with the Secretary of State in states in which the organization has employees.

Consider whether in those states it is necessary to apply for tax exemptions or to register with the attorney general.

3.3 Complying with fund-raising laws is a other important consideration.

4. **REGULATORY SCHEME FOR CALIFORNIA NONPROFIT PUBLIC BENEFIT CORPORATIONS**

4.1 Internal Revenue Service – Internal Revenue Code

4.2 Franchise Tax Board – Revenue and Taxation Code

4.3 Registrar of Charitable Trusts in the Attorney General’s office – Government Code and Business and Professions Code

4.4 Members and donors – Corporations Code² and Probate Code (Uniform Management of Institutional Finds Act)

Tip - Avoid having voting members by providing in bylaws that there will be no voting members. This will avoid gathering a quorum of members later to approve fundamental changes in the corporation.

Instead, use a staggered board of directors with three-year terms of office to avoid having the board re-elect itself en masse each year. Consider using designated directors for local chapters of national organizations and for private foundations.

If the organization must have voting members, assure that the membership outstanding for a fixed term and specify what a member must do to renew a membership for another term.

² The California Nonprofit Corporation Law provides for public benefit corporations, mutual benefit corporations and religious corporations. Most IRC Section 501(c)(3) organizations that are organized under California law (and are not churches) are public benefit corporations.

5. FUNDAMENTAL TAX ISSUES

5.1 Is the proposed activity exempt? Identify a revenue ruling or series of rulings that are closest to what the organization will do. Can it conform more closely to the ruling(s)? If it is not exempt or there are serious tax issues, find out before providing a fee estimate to the client or an hours estimate to your firm. If the organization is a church and might not need to file exemption applications, will it have other non-church activities that require the applications?

⇒ Nonprofit organization without a tax exemption: All of its receipts are probably IRC Section 61 income. Are any of its expenses “ordinary and necessary business expenses” that are deductible under IRC Section 162? If not, virtually all of its income is subject to corporate or trust tax.

5.2 Will the organization be a private foundation? The alternatives are a publicly-supported organization, a self-supporting organization (using income from its exempt activity) or a supporting organization. This affects the number and type of directors needed.

5.3 Will any of the officers or directors be paid by the organization? This increases the number of documents and the time needed to complete the project. Are the client’s compensation expectations reasonable? Discuss the IRC Section 4958 safe harbor and the need for outside directors and a compensation committee. Have the client obtain pay surveys and see if the numbers work.

5.4 If intellectual property is involved, will the nonprofit own it (the strong preference of the IRS) or be a licensee?

6. THE PROCESS

6.1 Most of the law office’s work takes place over 3 to 4 weeks. If you require prepayment of legal fees, consider holding the check and swapping it for a check from the organization when it opens its bank account, so that the client can write a check to the organization and not to you or your firm. It might help the client remember to take

the deduction, and also might be helpful in a tax audit of the client's charitable contributions.

- 6.2 Select the corporate name and reserve it.
- 6.3 Prepare draft articles, with custom purposes and, possibly, dissolutions clauses. Obtain client approval.
- 6.4 File articles of incorporation.
- 6.5 While the articles are cooking in the Secretary of State's office, prepare the incorporator's action, bylaws, initial directors action, application for an EIN, federal and California exemption applications, budget, power of attorney for the IRS, registration with the California Registrar of Charitable Trusts (part of the Attorney General's office) and a cover letter.³ If you want to provide an "operating manual" for the corporation, this is the time to prepare it. Ask for checks for the various filing fees.⁴
- 6.6 In the exemption applications, use the language of the revenue ruling(s) to the extent possible.⁵ It is probably not necessary to cite the ruling(s) at this point.
- 6.7 Receive the file-stamped articles of incorporation from the Secretary of State and send the whole package to the client.
- 6.8 Receive the client's comments and signed documents.

³ If the organization will pay a director or officer, it is helpful to have a conflict of interest policy signed by each director, and to have the board of directors appoint a compensation committee consisting of outside directors who will annually set the compensation of the paid insiders. This will speed the exemption application process.

⁴ Ask for a cashier's check for the IRS filing fee. This speeds the process a bit.

⁵ For this reason, the attorney should prepare the exemption applications based in information provided by the client.

- 6.9 Obtain the EIN. Have the client to open a bank account. Swap checks for legal fees.⁶ Add EIN to exemption applications and registration with the AG.
- 6.10 Try to assure that the organization uses an accountant who has experience with tax issues of nonprofit organizations. It is especially important that the accountant know and understand how the organization plans to avoid private foundation status, so that the accountant can monitor this from year to year. If it is a private foundation, the accountant needs to know the many special rules that apply to private foundations. Without this knowledge, the accountant cannot properly prepare the detailed tax return of the private foundation and its estimated tax returns.
- 6.11 Revise the exemption applications and budgets, obtain client approval. Advise the client that the IRS and FTB sometimes request additional information.⁷
- 6.12 File the exemption applications and budgets, register with the Attorney General's office.

The exemption applications should be filed as soon as possible after the articles of incorporation are filed.

Although the exemptions, if granted, will be retroactive to the date of incorporation as long as the exemption applications are filed with 15 months after that date, don't wait that long. If you do, there will be much more to disclose, more for the reviewers to pick over, more chances of footfalls by the client that will slow the application process. If necessary, push the client to review the draft exemption applications and sign the organization documents.

⁶ See 6.1 above.

⁷ Even if the IRS letter requesting additional information addresses a legal issue, it will begin "You forgot to include important information with your application."

- 6.13 Wait for three to six months for responses to the exemption applications. But wait *actively*. After four weeks, call to see if the applications have been assigned and to whom. In two more weeks, call and see if the reviewer has looked at the application yet.
- 6.14 Respond promptly in writing to any requests for additional information from the IRS or the FTB. If the responses indicate a concern about the exempt nature of the activities, discuss in your written response the revenue rulings and any helpful letter rulings or cases. Send highlighted copies of these with your response.⁸
- 6.15 When the determination letters arrive, tell the client to keep them and the applications with the organization's permanent records. If the organization is a publicly-supported or self-supporting organization, remind the client of the deadline for proving up this status. Explain the code reference in the FTB letter. Tell the client that this concludes your role in organizing the corporation.

[End of outline.]

⁸ Each request for additional information from the IRS can take at least 2-4 hours to handle, so it is best to anticipate issues and address them in the original exemption application.