



“Now That You’re Incorporated”

Observance of Corporate Formalities and Other Post-Incorporation Matters

About This Form: Public Counsel’s Community Development Project has designed the attached form memorandum to serve as a sample of follow-up advice that a volunteer attorney may give to a nonprofit client after its incorporation.

The information contained in this form is provided as of March 2020 and is subject to change. Any volunteer attorney using this form should verify the accuracy of the information before providing it to a client. Nonprofit organizations using this form should understand that it is the obligation of the nonprofit corporation’s board to stay informed of any changes. Public Counsel will update this form periodically for changes in law and recommended practices.

Important Notes: This form is provided for information only and does not take into account particular facts and circumstances relevant to any specific nonprofit corporation. Depending on such factors, including what legal steps and filings have already been completed by the nonprofit corporation, the specific provisions of the nonprofit corporation’s governing documents, and other facts relevant to the specific corporation, some language in this form may not apply to such corporation. In some cases, bracketed alternative language is provided. *This form should not be used “as is” but should be modified after careful consideration of the corporation’s particular circumstances.*

This form should not be construed as legal advice. Nonprofits reading this form should contact an attorney for legal advice about how the information in this form may apply to the corporation’s specific situation. Some corporations may need additional information not discussed in this form.

Public Counsel’s **Community Development Project** provides *free* legal assistance (including nonprofit incorporation) to qualifying nonprofit organizations that share our mission of serving low-income communities and addressing issues of poverty within Los Angeles County. If your organization needs legal assistance, or to provide comments on this form, visit www.publiccounsel.org/practice_areas/community_development or call (213) 385-2977, x 200.

[Date]

[Client Representative]

[Client Name]

[Address]

[City, State Zip]

Re: Observance of Corporate Formalities and Other Post-Incorporation Matters

Dear [Client Representative]:

We appreciate the opportunity to have assisted you and [Client Name] (the "Corporation") in its incorporation and application for recognition of exemption from federal income tax. We understand that our representation is now concluded [OPTIONAL: except for the purpose of completing the California tax exemption process].

Enclosed, please find the minute book for the Corporation, which contains a certified copy of the articles of incorporation, the original bylaws, and [other incorporation documents, e.g., incorporator's action, initial meeting of directors]. I am also enclosing [copies of the exemption applications, the Corporation's first statement by domestic nonprofit corporation and any documents not included in minute book]. The corporate secretary should retain all of these items in a safe place and have them readily available for inspection upon request.

Now that the Corporation has been formed, it will have numerous legal requirements in order to maintain its corporate and tax-exempt status. The requirements outlined in this memorandum derive from the California Corporations Code, which imposes various rules for a nonprofit public benefit corporation under California corporate law, the California Government Code, California Revenue and Taxation Code, and the Internal Revenue Code, which impose certain requirements in order to maintain tax-exempt status for both federal and state tax purposes. We encourage you to contact your attorney for further clarification or advice, or if you have any questions, please feel free to contact me at [Attorney contact information].

Sincerely,

[Attorney Name]

Enclosure

MEMORANDUM

TO: Directors and Officers of [Client Name]

FROM: [Attorney Name]

RE: Nonprofit Corporate and Tax-Exempt Requirements

This memorandum outlines the most frequently encountered legal requirements facing California nonprofit California corporations. The discussion of each topic is summary in nature and not exhaustive. **Specifically, Sections D.5, E.1 and E.2 of this memorandum include important information about filing requirements for all nonprofits. Failure to complete these filings on time may result in the suspension or revocation of the Corporation’s tax exemption or its corporate status in California.** It is very important that someone involved in the Corporation’s management reads this information carefully and calendars important dates. *I encourage you to contact an attorney for further clarification or advice.*

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A. Observance of Corporate Formalities and Meetings of Directors

Incorporating as a nonprofit corporation provides the Corporation with certain advantages, such as certain protections from liability, a perpetual business existence, and eligibility for special treatment under the tax codes. However, the Corporation can only enjoy these advantages if it maintains what are called “corporate formalities.” Corporate formalities are the basic rules and procedures for governing and operating a corporation (the Corporation’s bylaws describe many of these formalities). To keep its corporate status, the Corporation will need to follow and, most importantly, keep accurate records of all of these formal corporate activities.

Directors' meetings are perhaps one of the most important corporate formalities. Although there is no statutory requirement with respect to how frequently the board of directors should act, we suggest that the board of directors meet on a regular basis to deal with significant matters that have arisen during the fiscal quarter. Your organization’s bylaws mandate [_____ **meeting(s)**] of the board per year. Generally, board action may be taken by a majority of the directors present at the meetings, provided that the meeting contains a quorum (**[fill in the definition of quorum from the Corporation’s bylaws]**), and proper notice is observed. However, there are some actions under California corporate law that require approval of directors in office and not just a quorum, including removing a director without cause¹, approving a self-dealing transaction², and authorizing a committee of the board to act on behalf of the board³. **[Fill in other decisions that require a greater majority vote, if any, based on the Corporation’s bylaws]**. Alternatively, board action may be taken by the unanimous written consent of the directors without a meeting. *However, unanimous written consents should not replace board meetings altogether.*

Generally, matters appropriate for board action include the following⁴:

1. Election of officers, which must include a chairperson or president (the Corporation may elect to have both), a secretary, a CFO or treasurer (or both), and other officers as stated in bylaws or determined by the board (multiple offices may be held by the same person, except that neither the secretary nor CFO or treasurer may serve concurrently as president or chairperson);
2. Review of financial arrangements, including review of investments, opening and closing of corporate accounts, designation and change of corporate officers authorized as signatories, review of cash flow needs and review of financial statements;
3. Approval of material contracts and leases;
4. Policy decisions with respect to the expenditures of funds and the making of grants and ratification of those grants made;
5. Amendment of the articles of incorporation;

1 Cal. Corp. Code § 5222.

2 Cal. Corp. Code § 5233.

3 Cal Corp. Code § 5212.

4 See Cal. Corp. Code §§ 5140 and 5210.

6. Amendment, repeal, or adoption of bylaws;
7. Electing directors, filling vacancies on the board, and removing directors in some instances;
8. Appointing any board committees;
9. Employing and monitoring activities of the executive director/CEO, if any;
10. Adopting budgets;
11. Appointing auditors;
12. Complying with governmental reporting requirements;
13. Bringing or defending legal actions;
14. Approving indemnification of corporate directors, officers and other agents;
15. Approving corporate borrowing or loans;
16. Approving the mortgage or other hypothecation of corporate property to secure payment or performance of contracts or obligations;
17. Approving the sale, lease, conveyance, exchange, transfer, or other disposition of corporate assets;
18. Approving mergers, reorganizations and dissolutions; and
19. Any other matters not delegated to an officer of the Corporation.

The secretary of the Corporation should prepare minutes or a written consent form evidencing all board actions.

[Note that if the Corporation has members, they also have voting rights with respect to some of the above transactions, and this memorandum should be revised accordingly. See California Corporations Code §§ 5310-5354.]

The Corporation's board (or a board committee as provided in bylaws) must also review and approve any compensation (including benefits) for the Chief Executive Officer/President and Chief Financial Officer/Treasurer to verify that it is just and reasonable. Such review must be performed at the time of hiring, and whenever the compensation is modified or the employment term is extended.⁵

Also, any nonprofit corporation with annual gross revenues of more than \$2 million (not including amounts received from governmental agencies if the government requires the corporation to account for the money received) must have an audit committee of the board of directors, and must obtain an audit of the

⁵ See Cal. Gov't. Code § 12586(g).

corporation's financial statements that is approved by that committee. If the Corporation has \$2 million or more of gross revenues in any one year, you should consult an attorney about the audit committee requirements.

B. Directors' Duty of Care

Directors are considered fiduciaries of nonprofit organizations.⁶ Therefore, as a general proposition, a director must use due care by performing his/her duties in good faith, in a manner he/she believes to be in the best interest of the corporation, and with such care, including reasonable inquiry, as an ordinarily prudent person in a like position would use under similar circumstances. Each director has an obligation to ensure that the Corporation acts in accordance with its corporate purposes (as expressed in the Corporation's articles of incorporation and bylaws) and with all applicable laws.

The board of directors is generally responsible for managing the Corporation. Although the board may delegate some of the management functions and corporate powers to others, the acts of such delegates must always be under the board's ultimate control and direction. Directors must, therefore, use due care in delegating their authority.

In performing the duties of a director, the director is entitled to rely on information, opinions, reports or other statements (including financial statements and data) prepared by officers or employees of the Corporation, legal counsel, independent accountants, or other persons, so long as the director has a reasonable belief in the presenter's reliability, competence, and/or expertise and acts in good faith. The director may be obligated to conduct a reasonable inquiry into the information to be relied upon when the need for such inquiry is indicated by the circumstances. Of course, a director may not rely on any information received when he or she has knowledge of facts that would cause such reliance to be unwarranted.

Members of the board should also be aware that special duties are required with regard to assets held by the Corporation for investment. The board must avoid speculation, consider the probable income of the investment, as well as the probable safety of the Corporation's capital, and comply with any agreement pursuant to which assets are contributed to the Corporation.⁷

C. Directors' Duty of Loyalty

Directors are obligated to act in the best interests of the Corporation and all of its members, including the members of any minority factions, and to administer their corporate powers for the common benefit. Several issues as discussed below come up repeatedly in the operation of nonprofit corporations, and should be kept in mind as directors exercise their duties.

1) Interested Directors

No more than 49% of the directors of the Corporation may be "interested persons," i.e., directors currently being compensated for services rendered to the Corporation during the past year (excluding reasonable compensation paid to them for serving as directors), or their close relatives. Any compensation other than

⁶ See *Scheuer Family Foundation, Inc. v. 61 Associates*, 179 A.D.2d 65, 582 N.Y.S.2d 662 (1st Dept. 1992).

⁷ See Cal. Corp. Code § 5240 for requirements relating to assets held for investment.

amounts paid for service as directors, regardless of the amount, will make a director an "interested person" for this purpose. Under the interested person rule, fewer than half the directors can be made up of officers, employees, consultants, or their close relatives, and more than half must be "outside" directors who do not receive any compensation from the Corporation other than for serving as a director.

2) Corporate Opportunity

If a director becomes aware of an opportunity or transaction that would be of interest or benefit to the Corporation, the director generally must disclose such opportunity to the Corporation and permit it to take advantage of the opportunity, if it so desires. If such an opportunity is presented, and the Corporation declines to act, the director may then pursue the transaction for his/her own advantage.

3) Self-Dealing

"Self-dealing" transactions are those in which the Corporation is a party and in which one or more of its directors has a "material financial interest."⁸ A director with a material financial interest in the transaction is termed an "interested director." Transactions in which a director has a material financial interest are not prohibited completely, but are permitted only if the Corporation is acting in its own interest and for its own benefit, and the transaction is approved by one of the following methods:

1. Approval by the California Attorney General (please note that this is the only method by which a loan to or a guarantee of an obligation of a director or officer can be approved), or by a court in an action in which the Attorney General is a party. In most cases, this alternative will not likely be useful.
2. Approval by the board of directors (or, in certain limited circumstances, a committee of the board) of the transaction, which must be obtained before any part of the transaction is consummated. In addition, the transaction must be fair and reasonable to the Corporation at the time it is entered into. The board's authorization or approval of the transaction must be in good faith, made by directors with knowledge of the material facts concerning the transaction and the directors' interest in the transaction, and approved by a vote of a majority of the directors then in office (rather than a majority of a quorum) without counting the vote of an interested director(s).

If the transaction is approved by the board of directors without Attorney General approval, then either (i) before approving the transaction, the board must reasonably investigate and consider alternative arrangements and in good faith determine that the Corporation could not obtain a more advantageous arrangement with reasonable effort under the circumstances, or (ii) the transaction terms must be such that in fact, the Corporation could not have obtained a more advantageous arrangement with reasonable effort under the circumstances.

⁸ See Cal. Corp. Code §5233(b) which enumerates transactions that are *not* considered "self-dealing transactions". Unfortunately, "material financial interest" is not defined under the code.

D. Tax Matters

1) Employer Identification Number

The Corporation has applied for and received a federal employer identification number (“EIN”) that will be used on its federal tax returns and certain other documents. For your reference, that number is **[insert EIN number]**.

2) Maintaining Federal Tax-Exempt Status and Public Charity Status

a) Limit On Activities That Do Not Further Charitable Purpose

In order to maintain tax-exempt status, an organization must continue to meet each of the requirements that qualified it for federal tax exemption in the first place. In particular, an organization must be operated primarily for the charitable purposes set forth in its organizational documents (e.g., articles of incorporation and bylaws). Non-charitable activities are permitted only if they are insubstantial (for example, in terms of time and money expended) in relation to charitable activities. In evaluating an organization’s primary purpose, the IRS will consider the particular manner in which activities are conducted, including whether they are conducted in a commercial manner, their scope, and the amount of profit generated by them. Any change in the activities or purposes of the Corporation must be monitored to ensure that it continues to comply with the purposes set forth in the articles of incorporation and bylaws. In addition, any changes to the articles of incorporation or bylaws must not permit the Corporation to engage in activities that are not in furtherance of its exempt purposes, except as an insubstantial part of the Corporation’s activities. Changes to the articles of incorporation or bylaws may require notifying the appropriate federal and state regulatory agencies (see [Section E.7\(c\)](#)).

b) Limit On Private Benefit and Inurement

The net earnings of an exempt organization may not benefit organizational “insiders,” and the organization’s activities may not confer a direct or indirect benefit on any private persons.

c) Prohibition On Political Activity and Limit On Lobbying

The organization may not participate or intervene in any campaign for or against a candidate running for office. Also, a substantial part of the organization’s activities cannot consist of carrying on propaganda or attempting to influence legislation (i.e., “lobbying”). Organizations may elect to use the expenditure test (also known as the “501(h) election”), which provides clear amounts of how much an organization can spend on lobbying. Organizations can make this 501(h) election by filing Form 5768⁹. Please consult an attorney for further clarification on lobbying limitations.

An organization that fails to meet the above requirements on an ongoing basis may face penalties from the IRS or, in some cases, lose its exemption from federal income tax. (*Note:* To the extent that exemption from

⁹ Form 5768 and instructions are available at <https://www.irs.gov/pub/irs-pdf/f5768.pdf>. For more information on the 501(h) election, see Alliance for Justice’s publication “Worry-Free Lobbying for Nonprofits” at http://www.bolderadvocacy.org/wp-content/uploads/2012/10/Worry_Free_Lobbying_paywall.pdf.

other taxes, such as the California franchise tax (discussed below), depends on meeting the requirements for federal exemption, losing federal tax exemption also may cause the loss of such other exemptions.)

d) Public Charity Status

As a reminder, the Corporation applied for tax exemption as a “public charity”. Organizations designated as public charities will usually be described under either Internal Revenue Code § 509(a)(1) and 170(b)(1)(A)(vi) or § 509(a)(2). The IRS has determined that the Corporation can reasonably be expected to be publicly supported and has automatically classified the Corporation as a public charity under § **[fill in section stated on determination letter: 509(a)(1) and 170(b)(1)(A)(vi) or 509(a)(2)]** for its first five years (until **[mo/day/year]**).

[Alternatives: By filing a Form 1023-EZ, you attested on the Form 1023-EZ that you expect the Corporation normally will satisfy the public support test required for this designation as a public charity and either:

- receive at least one-third of its support from public sources, or receive at least 10 percent of its support from public sources and have other characteristics of a publicly-supported organization. Based on your expectation, the Corporation’s classification as a public charity under § 509(a)(1) and 170(b)(1)(A)(vi) will continue for five tax years from the date of exemption (**[until mo/day/year]; or**
- receive more than one-third of its support from a combination of gifts, grants, contributions, membership fees, and gross receipts (from permitted sources) from activities related to your exempt functions and normally receive not more than one-third of its support from investment income and unrelated business taxable income. Based on your expectation, the Corporation’s classification as a public charity under § 509(a)(2) will continue for five tax years from the date of exemption (**[until mo/day/year].]**

Donors will be entitled to rely on the tax determination letter in making donations to the Corporation unless the IRS changes the Corporation’s status and publishes a notice of the change. The Corporation must inform the IRS of any change in its sources of support, purpose, character or method of operation, and any amendments to its articles of incorporation or bylaws (see [Section E.7\(c\)](#)).

e) Public Support Test to Maintain Public Charity Status and Recordkeeping

Beginning with its sixth taxable year **[(Month-Month Year)]**, the Corporation must establish that it is a public charity by showing that it meets the public support test under § 509(a)(1) and 170(b)(1)(A) **or** § 509(a)(2) on Schedule A to Form 990/990-EZ.

Public Support Test

To qualify as a public charity under § 509(a)(1) and 170(b)(1)(A)(vi), the Corporation must either:

- receive at least 33 1/3% of its support from governmental units or contributions made directly or indirectly by the general public,¹⁰ **or**
- receive at least 10% of its support from these sources and demonstrate “facts and circumstances” sufficient to support its classification as a publicly supported organization, such as a program geared towards continuous solicitation of funds.

In the alternative, to qualify as a public charity under § 509(a)(2), the Corporation must receive more than 33 1/3% of its support from governmental units or contributions made directly or indirectly by the general public, including gross receipts from exempt purpose activities such as charitable sales of merchandise, and must receive NOT more than 33 1/3% of its support from the sum of its gross investment income and its net (after tax) unrelated business income (see [Section D.3](#)).

Self-monitoring of public support status is also important for corporations that are eligible to file Form 990-N (currently those with gross receipts of up to \$50,000). A public charity that qualifies to file and files Form 990-N is not required to file Schedule A. If the Corporation is eligible to file Form 990-N during its sixth year or after and no longer qualifies as a public charity, it is required to self-declare to the IRS that it is a private foundation and file the 990-PF.¹¹

If the Corporation cannot meet the public support test for two consecutive years, it will lose its public charity status and be reclassified as a private foundation as of the start of the second consecutive year. Private foundations are also tax-exempt, but are subject to additional rules and excise taxes. They are required to pay federal excise tax in estimated quarterly installments, and are subject to other taxes and restrictions that are beyond the scope of this memorandum. Please consult with an attorney or accountant regarding applicable requirements if the Corporation is reclassified as a private foundation.

Recordkeeping

The Corporation should keep track of its public support information (i.e., records of who donated funds and how much was donated) throughout the year instead of waiting until the end of the tax year when it is preparing Schedule A to Form 990/990-EZ. Also, the Corporation should calculate whether it is meeting the public support test during its first five years of existence to address and correct any public support issues before the sixth year. Since these are highly technical calculations, the Corporation should consult with an attorney or accountant for more detailed information on these tests.

3) Unrelated Business Income Tax (UBIT)

A nonprofit organization otherwise exempt from federal income tax is taxed on net income realized from a regularly conducted trade or business that is unrelated to the organization’s exempt purpose. This is referred to as “unrelated business taxable income” or “UBTI”. (*Note:* Such a business must be “insubstantial” or the

¹⁰ Note there is a 2% limitation for a gift, grant, or contribution received from any source (other than a governmental unit or a public charity). These contributions would generally be considered public support to the extent they amount to 2% of the total support received over the five-year period.

¹¹ Note that these tests do not apply to supporting organizations as defined under Internal Revenue Service Code section 509(a)(3). **[If the Corporation is a supporting organization, the attorney should revise this memorandum accordingly.]**

organization will lose tax-exempt status altogether, as described in [Section D.2\(a\)](#)). Generally, a trade or business is an activity that involves selling goods or services to produce income. The fact that profits from such activity are essential to the organization’s ability to carry out its exempt purpose does not turn an “unrelated” business into a “related” one. Instead, the business must be connected to the exempt purpose by more than the mere production of funds in order to avoid the tax on net income.

Dividends, interest, annuities, royalties, capital gains, the sale of donated goods, or revenue generated solely by the efforts of volunteers are *excluded* from UBTI in most circumstances because they are not generated from a trade or business. Because of these exclusions, consideration should be given to structuring transactions to produce one of these types of income where feasible. For example, publication and sale of a book by an exempt organization may result in income taxed as UBTI, but a royalty received as a result of a transfer of publication rights to a commercial publisher may not.

Even if there is an unrelated trade or business, its net income is only taxed if the business is *regularly* carried on. In determining whether a trade or business is regularly carried on, the frequency and continuity of the business are compared with the frequency and continuity of a similar business conducted by a non-exempt organization. Generally, an activity is not regular if it is carried on only one or two weeks per year. Infrequent conduct such as an annual fundraising event is not regular.¹² Because the determination of whether a trade or business is unrelated or regularly carried on depends on the particular facts of each situation, you should consult with an attorney for further advice on the specific activities of the Corporation.

4) Other Taxes

a) California Franchise Tax

The California franchise tax is the equivalent of an income tax assessed on the net income of corporations doing business in California. Certain nonprofit organizations are exempt from the California franchise tax.

Alternative 1: [However, such exemption is not automatic. In order to qualify, the Corporation must file Form FTB 3500A with a copy of its federal determination letter and receive a letter acknowledging receipt and specifying the effective date of its exemption under California law.¹³ Form FTB 3500A is available at <https://www.ftb.ca.gov/forms/misc/3500a.pdf>.

Alternative 1A: [However, such exemption is not automatic. In order to qualify, the Corporation must file Form FTB 3500 and receive a “determination letter” from the California Franchise Tax Board.¹⁴ Form FTB 3500 is available at <https://www.ftb.ca.gov/forms/misc/3500.pdf>.]

¹² See Public Counsel’s publication “Anatomy of a Fundraiser” available at <http://www.publiccounsel.org/tools/publications/files/0246.pdf> for more information.

¹³ Form 3500A provides an expedited review process, but the Corporation must obtain a determination of federal tax-exempt status from the IRS before it can file.

¹⁴ If the Corporation wishes to file for California nonprofit tax exemption before having obtained its federal tax-exempt status, the Corporation must file Form 3500 with the Franchise Tax Board.

Alternative 2: [The Corporation has applied for tax exempt status from the California Franchise Tax Board by filing Form FTB 3500A with a copy of its federal determination letter. The Corporation will receive a letter acknowledging receipt and specifying the effective date of its exemption under California law from the Franchise Tax Board.]

Alternative 2A: [The Corporation has applied for tax exempt status from the California Franchise Tax Board by filing Form FTB 3500, and if the exemption is granted, the Corporation will receive a “determination letter” from the Franchise Tax Board.]

If the Corporation conducts activities outside of California, it should consult with an attorney to determine whether it needs to apply for tax-exempt status in those other jurisdictions.

b) Sales and Use Taxes

Even though the Corporation is tax exempt, it is still generally subject to state and local sales and use taxes if it engages in the sale of tangible personal property. Refer to the California Department of Tax and Fee Administration website at <https://www.cdfta.ca.gov/taxes-and-fees/sutprograms.htm> for more information about whether your Corporation’s activities might subject it to such tax or whether the activities may be exempted.

c) Local Business License Taxes

Some cities, including Los Angeles, impose business license taxes on all businesses conducted within the city. Tax-exempt organizations generally are exempt from such taxes, but certain actions may be required to qualify for exemption. For example, in the City of Los Angeles, the Corporation must file a business license tax exemption application documenting that it is tax exempt. For more information about the City of Los Angeles business tax exemption, visit the City of Los Angeles Office of Finance website at <http://finance.lacity.org/>.

d) Property Tax

If the Corporation owns property in California, it is not automatically exempted from paying property taxes by virtue of its federal or state tax-exempt status. All property in California is taxable unless exempt under the laws of the United States or the California Constitution. Under California law, the Legislature may exempt property from taxation if the property is used exclusively for religious, hospital, scientific, or charitable purposes and is owned or held in trust by corporations or other entities (1) that are organized and operating for those purposes, (2) that are nonprofit, and (3) whose net earnings do not inure to the benefit of any private shareholder or individual.¹⁵

If you believe the Corporation qualifies for the “welfare” exemption described above, you must obtain an Organizational Clearance Certificate for the Corporation from the California State Board of Equalization (“BOE”) by filing Form BOE-277 (available at www.boe.ca.gov/proptaxes/pdf/boe277.pdf) with the

¹⁵ A charter school operated as or by a nonprofit public benefit corporation may be exempt from property tax as a “public school” pursuant to the California Revenue and Taxation Code § 202(a)(3).

Assessment Policy Standards Division of the BOE. After the Corporation obtains this certificate, the Corporation must first apply for an initial exemption and then continue to file for an exemption from payment of property tax for a particular parcel of property on an annual basis. The claim for exemption should be filed each year on or before February 15 with the county assessor in the county in which the property is located. Forms BOE-267 and BOE-267-A are the relevant forms and should be available on the county assessor's website (for Los Angeles County visit: <https://assessor.lacounty.gov/forms-2/>.)

e) Employment Taxes

Most nonprofit corporations with employees must generally withhold federal income taxes, and social security and Medicare (FICA) taxes from wages paid to employees. Failure to properly withhold federal income taxes may result in personal liability for directors or officers of the organization. For more information, the Corporation should refer to IRS Publication 15 (Circular E) Employer's Tax Guide (www.irs.gov/pub/irs-pdf/p15.pdf). Additionally, refer to Publication DE 44 - California Employer's Guide (www.edd.ca.gov/pdf_pub_ctr/de44.pdf), which addresses the various California employer withholding and taxpaying obligations. Because of the extensive recordkeeping and reporting requirements involved, we strongly urge you to discuss these requirements with an attorney or accountant.

5) Tax Returns

Both federal and California tax returns must be filed each year, generally on or before the fifteenth day of the fifth month following the close of the Corporation's taxable year **[insert Corporation's taxable year and filing date (e.g., May 15 for a corporation with a December year-end)]**.

The following descriptions are intended to provide *general information only*. It is important that you consult your accountant regarding additional requirements that may be applicable to your Corporation, including, if applicable, special requirements for private foundations.

a) Federal

The basic federal annual return form is IRS Form 990/990-EZ, "Return of Organization Exempt from Income Tax."¹⁶ Certain organizations are exempt from this filing requirement, including churches and organizations (other than private foundations) with annual gross receipts that are normally \$50,000 or less. However, organizations that are exempted under this threshold – annual gross receipts of \$50,000 or less – must file IRS Form 990-N, an annual electronic notice form known as the "e-Postcard."¹⁷ This form can be filed at [Form 990-N Electronic Filing System \(e-Postcard\)](#). **Failure to file a return or an e-Postcard, as required, with the IRS for three consecutive years will lead to automatic revocation of federal (and likely state) tax-exempt status.**

¹⁶ Form 990 and instructions are available at <https://www.irs.gov/pub/irs-pdf/f990.pdf>, and <https://www.irs.gov/pub/irs-pdf/i990.pdf>, respectively. Form 990-EZ and instructions are available at <https://www.irs.gov/pub/irs-pdf/f990ez.pdf> and <https://www.irs.gov/pub/irs-pdf/i990ez.pdf>, respectively.

¹⁷ For more information on Form 990-N, please see <https://www.irs.gov/charities-non-profits/annual-electronic-filing-requirement-for-small-exempt-organizations-form-990-n-e-postcard>

Additionally, IRS Form 990-T, “Exempt Organization Business Income Tax Return,” must be filed by an organization that earns more than \$1,000 in gross income deriving from an unrelated trade or business for the taxable year (as discussed in [Section D.3](#)). Form 990-T and instructions are available at <https://www.irs.gov/uac/form-990-t-exempt-organization-business-income-tax-return>.

b) California State

California’s basic annual return form is FTB Form 199, “Exempt Organization Annual Information Return.”¹⁸ Note that churches and religious orders are not required to file Form 199. Organizations with annual gross receipts that are normally \$50,000 or less must file FTB Form 199-N (the “California e-Postcard”), which is an electronic notice similar to IRS Form 990-N. This form can be filed at <https://www.ftb.ca.gov/file/business/types/charities-nonprofits/199N.asp>. **Failure to file a return or a California e-Postcard, as required, with the FTB for three consecutive years will lead to automatic revocation of state tax-exempt status.**

In addition, if the Corporation has gross taxable income derived from an unrelated trade or business in excess of \$1,000 for the taxable year, it must file FTB Form 109, “Exempt Organization Business Income Tax Return” (as discussed in [Section D.3](#)).

E. Other Post-Incorporation Matters and Filing Requirements

In addition to observing the requisite corporate formalities, the Corporation is subject to numerous other legal requirements. Although not intended to be exhaustive, the following list summarizes legal requirements that a new California nonprofit corporation should be aware of. Certain requirements are highly formal and technical, and many must be satisfied within a specified time period. Failure to comply with these legal requirements may subject the Corporation to fines or other penalties and potentially suspension or revocation of tax-exempt status.

1) Statement of Domestic Nonprofit Corporation – Biennial Filing Required

The Corporation must, within 90 days after the filing of the original articles of incorporation and biennially thereafter in the month of the anniversary of the incorporation date **[insert Corporation’s incorporation date]**, file a Statement of Information (Form SI-100) with the California Secretary of State, providing: (1) the names and complete business or residence address of its CEO, secretary, and CFO, and (2) the street address of its principal office. The statement also must designate a natural person or corporation as agent for the service of process. For your reference, the Corporation’s entity number with the Secretary of State is **[insert Corporation’s entity number]**.

Whenever certain information changes, the Corporation may file a current statement with the Secretary of State. However, if there is an update to the designation of an agent for service of process, the Corporation

¹⁸ For information on FTB filing requirements for charities and nonprofits, please see <https://www.ftb.ca.gov/file/business/types/charities-nonprofits/annual-and-filing-requirements.html>.

must file a current statement with the Secretary of State. This form is available at http://bpd.cdn.sos.ca.gov/corp/pdf/so/corp_so100.pdf. Alternatively, the Corporation may file the form online at <https://businessfilings.sos.ca.gov>. **Failure to file in a timely fashion could result in suspension of the Corporation's corporate status.**

2) Filing With the California Attorney General's Registry of Charitable Trusts – Registration and Annual Filing Required

The Corporation must register with the Registry of Charitable Trusts of the California Attorney General's office within 30 days of the organization's initial receipt of assets. The Corporation should register before engaging in charitable solicitations in California. The registration form (Form CT-1) is available on the Attorney General's website at <http://oag.ca.gov/sites/all/files/agweb/pdfs/charities/charitable/ct1-form.pdf>.

The Corporation also must file annually Form RRF-1, a disclosure reporting form, which must be filed within four months and fifteen days after the end of the Corporation's taxable year **[(insert Corporation's taxable year end date and date RRF-1 is due)]** unless the Corporation has received an extension of time to file its federal income tax return, in which case the Form RRF-1 (together with copies of any extension from the IRS) should be filed at the same time as the federal tax return. The report provides accountability to the public and to the Attorney General in its role as legal representative of the public interest. The Corporation must submit a copy of its Form 990, 990-EZ, or 990-PF along with Form RRF-1. Form RRF-1 and instructions can be found on the Attorney General's website at <http://oag.ca.gov/charities/forms>. Organizations with annual revenues under \$50,000 are required to file Form CT-TR-1 along with Form RRF-1. Form CT-TR-1 asks for a balance sheet (cash, savings, investments, land, other assets, accounts payable, salaries payable, and other liabilities) and a statement of revenues and expenses (cash and non-cash contributions, program revenue, investments, special events, compensation, fundraising expenses, rent, utilities, supplies, insurance, and other expenses and revenue). This form is meant to provide the Attorney General with financial information about the charity that would otherwise be provided on IRS Form 990 or 990-EZ. **Failure to file Form RRF-1 in a timely fashion could result in revocation of the Corporation's state tax exemption for the year in question and substantial penalties.**

3) Business Licenses

The Corporation may be required to obtain a business license or an exemption from the license requirement from the city in which it intends to operate. In the City of Los Angeles, tax-exempt organizations must obtain a business license, called a "Tax Registration Certificate", from the Office of Finance (<http://finance.lacity.org/>). Please see [Section D.4\(c\)](#) for information about applying for the Los Angeles business tax exemption.¹⁹

¹⁹ Information about business licenses and other permit requirements in California can be found at www.calgold.ca.gov.

4) Local Solicitation Ordinances – Filing Required Before Fundraising Campaign or Event

In connection with fundraising activities, the Corporation may also be required to register with various counties, cities, and states around the country under those jurisdictions' statutes and ordinances regulating solicitation. For instance, solicitation registration is required by the City of Los Angeles. At least 15 business days before the start of any fundraising campaign or special event in Los Angeles, the Corporation must complete and file a "Notice of Intention" (available at www.lapdonline.org/police_commission/pdf_view/6195) with the Los Angeles Police Commission's Charitable Services Section. After investigation, the Corporation will be issued an Information Card containing important facts to be considered by a prospective donor. The Corporation should not begin soliciting contributions until it has been issued an Information Card, and must give or display a copy of the Card to all persons solicited by the Corporation, including recipients of fundraising mailing appeals. The original Card must also be exhibited conspicuously at the site of special events. Finally, a report showing receipts, expenditures, and distributions of net proceeds of any fundraising campaign or special event must be signed by two officers of the Corporation and filed within 30 days of the termination of the campaign or special event (available at www.lapdonline.org/home/pdf_view/6196).

In addition to the above reporting requirements, the Corporation must maintain an accounting system in accordance with established accounting principles, and be prepared to give each donor a signed receipt for contributions. For a full listing of charitable solicitation guidelines in the City of Los Angeles, contact the Police Commission's Charitable Services Section at (213) 996-1260 or visit www.lapdonline.org/police_commission/content_basic_view/9147.

5) Other Fundraising Laws

a) The Nonprofit Integrity Act of 2004

Pursuant to the Nonprofit Integrity Act, the Corporation must conduct all fundraising activities without coercion and must not engage in any misrepresentation regarding the purpose or beneficiary of any fundraising solicitation. The Corporation must also approve every written contract entered into in connection with a fundraising activity conducted on its behalf. The act also governs contracts between charities and commercial fundraisers. If the Corporation intends to hire a commercial fundraiser to conduct a fundraising event or solicitation, you should review the provisions of California Government Code §§ 12599 *et seq.* and consult an attorney with any questions.²⁰ You can find a detailed summary and frequently asked questions about these laws, including a list of specific actions that are prohibited in connection with fundraising, on the California Attorney General's website at <http://oag.ca.gov/charities>.

b) Federal Substantiation Requirements for Charitable Contributions

Donations to a 501(c)(3) organization are generally tax deductible. While it is normally the responsibility of the donor to prove to the IRS that he/she has made a tax-deductible donation, the Corporation should provide the documentation necessary for a donor to do so.

²⁰ See also http://oag.ca.gov/sites/all/files/pdfs/charities/publications/nonprofit_integrity_act_nov04.pdf.

A donor must have a bank record or written communication from the Corporation for any monetary contribution before the donor can claim a charitable deduction on his/her federal income tax returns. For any single donation of \$250 or more, a donor needs a specific kind of contemporaneous, written acknowledgment from a charitable organization. The written acknowledgment must include the following information:

- (1) Name of organization;
- (2) Amount of cash contribution;
- (3) Description (but not the value) of non-cash contribution;
- (4) Statement that no goods or services were provided by the organization in return for the contribution, if that was the case; and
- (5) Description and good faith estimate of the value of goods or services, if any, that an organization provided in return for the contribution.

The Corporation can send a separate acknowledgment for each donation or it can send an annual acknowledgment substantiating each separate donation. Although the written acknowledgment is only required for donations of \$250 and above, a nonprofit may also (and often should) send a similar acknowledgment for all donations it receives. Many nonprofits email or mail a computer-generated acknowledgment letter for every donation received over their websites.

In addition, the acknowledgment must be contemporaneous. An acknowledgment is considered contemporaneous if the taxpayer obtains it on or before the earlier of the date he/she files his/her yearly tax return or the due date for filing the return. Typically organizations send an acknowledgment no later than January 31 of the year following the donation.

If a donor receives a good or service in return for his/her donation (known as a “*quid pro quo*”), only the contribution in excess of the fair market value of what was received is deductible. *For any contribution in excess of \$75 (not the total deduction) for which the donor receives something in return, the charitable organization is required to provide a written disclosure to the donor.* The written disclosure must:

- (1) inform a donor that the amount of the contribution that is deductible for federal income tax purposes is limited to the excess of the money contributed by the donor over the value of the goods or services provided by the donation; and
- (2) provide a donor with a good faith estimate of the goods or services.

It is best practice to provide an acknowledgment for all contributions and to keep accurate records of all donations. IRS Publication 1771 – Charitable Contributions: Substantiation and Disclosure Requirements (www.irs.gov/pub/irs-pdf/p1771.pdf) and IRS Publication 526 – Charitable Contributions (www.irs.gov/pub/irs-pdf/p526.pdf) set forth the specific details with respect to substantiation of deductible contributions, including the type of information that should and should not be included in these acknowledgements.

c) Common Fundraising Activities

Auctions, Sales, and Boutiques

Nonprofit organizations often raise money through the sale of goods and services – e.g., silent auctions, holiday boutiques, bake sales, carwashes, or selling logo items. Sales and use tax applies to the sale or use of tangible personal property in California (see [Section D.4\(b\)](#)). Nonprofit organizations are not exempt from these taxes and may be subject to either tax depending on the nature of a particular fundraising activity. Organizations must obtain a seller’s permit if they are engaged in business in California and intend to sell or lease tangible personal property that would ordinarily be subject to sales or use tax if sold at retail, unless certain limited exceptions apply to the particular sales activity. A nonprofit can obtain a seller’s permit at the California Department of Tax and Fee Administration (CDTFA) website at <https://onlineservices.cdtfa.ca.gov/Directory/> or at a CDTFA field office (list of field offices available at <https://www.cdtfa.ca.gov/office-locations.htm>). A nonprofit will need to file its sales and use tax return by the last day of the month following the sales event or, if issued a regular permit, on a monthly, quarterly, or annual basis (depending on estimated sales). A nonprofit may be required to pay UBIT on income derived from a regularly carried on trade or business not substantially related to its exempt purpose. Many popular fundraising activities involving the sale of goods or services, however, will fall under an exemption to UBIT – e.g., sale of donated goods, activities not regularly carried on, volunteer-led activities. If the Corporation plans to fundraise through the sale of goods and services, it should consult an attorney or accountant to make sure that it will not have to pay UBIT on the income generated from the sales activities.

Raffles

California law permits a charity that has been tax-exempt in California for at least one year to hold raffles if at least 90% of the gross receipts of the raffles are used for beneficial or charitable purposes. Note that separate registration and reporting with the Attorney General’s office is required on Forms CT-NRP-1 and CT-NRP-2, respectively. The registration period for conducting raffles is September 1 through August 31 annually. For additional information and the required forms, see <http://oag.ca.gov/charities/raffles>.

For a comprehensive overview on issues related to charitable fundraising (including other activities that have special rules like poker, bingo, and commercial co-ventures), see Public Counsel’s publication “Anatomy of a Fundraiser” at <http://www.publiccounsel.org/tools/publications/files/0246.pdf>.

d) Fundraising in Other States

Each state has its own rules and regulations regarding charitable registration, and these rules may often vary widely and require supplemental forms. Currently, there is no single registration form that can be used to fundraise and solicit donations in all states, and it is strongly recommended that organizations review the charitable registration requirements in each state. However, the Unified Registration Statement, a charitable registration statement accepted by certain states, is available at www.multistatefiling.org/index.html. Note that the Unified Registration Statement should be used with caution as many states are no longer accepting it because of changes and updates in each state’s requirements. Before conducting any fundraising activities in other states or online, the Corporation should consult with an attorney to determine whether it needs to register in another jurisdiction.

6) Insurance

Nonprofit organizations require at least a minimal level of insurance to protect against business risks to which all organizations are, to some extent, vulnerable. You should take the time to assess whether your organization may have exposure in any one of seven broad areas: property, directors and officers, crime, automobile, liability, employment practices, or workers' compensation. Almost all organizations will require commercial general liability insurance, which covers negligent acts performed by the organization or its employees. Directors and officers insurance may also be important if the organization wishes to attract qualified volunteer board members. While California law protects volunteer directors and officers of certain types of nonprofit corporations from liability for actions within the scope of their duties that are taken in good faith in a manner believed to be in the best interest of the corporation, some of these protections are only available to organizations that have purchased a specified amount of liability insurance. California nonprofit organizations may acquire insurance through the Nonprofits' Insurance Alliance of California (www.niac.org), a nonprofit liability insurance pool established exclusively for nonprofit organizations in California. For a more detailed guide to insurance issues, see Public Counsel's publication "A Nonprofit's Guide to Risk Management and Insurance" (http://www.publiccounsel.org/tools/publications/files/risk_management.pdf).

7) Recordkeeping and Reports

a) Recordkeeping

The Corporation is required by law to keep up-to-date originals or copies of (1) books and records of account; (2) minutes of the meetings of its members (if any), board and committees of the board; (3) a record of its members (if any) giving their names and addresses and the class of membership held by each; and (4) business records relating to the amount, cost, and value of all property that the Corporation owns, claims, possesses and/or controls. In addition, the Corporation must keep the following documents at its principal office and available for inspection:

1. Articles of Incorporation and all amendments thereto.
2. Corporate bylaws and all amendments thereto.
3. Copies of the Corporation's tax exemption applications (any federal forms including Form 1023 or Form 1023-EZ and California state forms Form FTB 3500/3500A) and tax determination letters.
4. Information returns on Forms 990/990-EZ/990-N filed with the IRS and Forms 199/199N filed with the FTB (three most recent years only).

As described above (see [Section D.2\(e\)](#)), the Corporation should keep records of all of its revenues and expenses for tax reporting purposes, and to prove its public charity status to the IRS.

b) Annual Report

A California nonprofit public benefit corporation that receives at least \$25,000 or more in gross revenues in any fiscal year must send an annual report to each director and member (if any) within 120 days after the

close of the Corporation's fiscal year. In addition to information regarding loans, indemnifications, and self-dealing transactions referenced in the next paragraph, the annual report should contain a statement of assets and liabilities and revenues and expenses in appropriate detail.²¹

If the Corporation does not produce the annual report, it must still furnish to the board and members (if any) a statement on the following types of loans, indemnifications and self-dealing transactions:

1. A brief description of the amount and circumstances of any loans, financial guarantees, advances, or indemnifications totaling more than \$10,000 made the previous year to any officer or director of the Corporation.²²
2. A brief description of the amount and circumstances of any transaction in which the Corporation was a party and a member of the board or an officer of the Corporation had a direct or indirect financial interest, involving more than \$50,000.²³

c) Required Federal and State Filings for Amendment of Articles or Bylaws

To amend the articles of incorporation, a certificate of amendment must be filed with the Secretary of State. Once accepted, the Secretary of State forwards one copy to the Attorney General. The Corporation must then submit a copy of the amended articles with its California information return (Form 199) to the Franchise Tax Board for the year in which the amendment became effective. Similarly, if the Corporation's bylaws are amended, the Corporation must report the amendment to the Franchise Tax Board by filing the amendment with the applicable tax returns for the year in which the amendment became effective. Changes must also be reported to the Attorney General either on the Corporation's next Form RFF-1 or by mailing a copy of the amended bylaws to the Attorney General.

The Corporation must also notify the IRS of an amendment to its articles of incorporation or bylaws for the year in which the amendment became effective. If the Corporation files a Form 990 or 990-EZ, the amendment must be described in Schedule O. If the Corporation files a Form 990-N, it must report the amendment to the IRS Exempt Organizations Determinations Office. For more information about reporting changes to the articles and bylaws to the IRS, please refer to the instructions to the Form 990 or 990-EZ or <https://www.irs.gov/charities-non-profits/exempt-organizations-material-changes>.

In addition, the Corporation must report new, significant program services or significant changes in how it conducts program services on its annual state and federal returns.²⁴

²¹ See Cal. Corp. Code § 6321. The annual report may be sent less often than annually if member meetings are held less often than annually – the annual report need be made only with the frequency with which regular membership meetings are required, unless otherwise stated in the articles or bylaws.

²² Cal. Corp. Code § 6322. Note that as a general rule, California nonprofit public benefit corporations may not lend money or property to, or guarantee the obligations of, their directors or officers, unless an exception applies or Attorney General approval is obtained. (Cal. Corp. Code § 5236).

²³ Cal. Corp. Code § 6322.

²⁴ See Public Counsel's publication "Notification Requirements for California Public Benefit Corporations" at <http://www.publiccounsel.org/tools/publications/files/0239.pdf> for more information on how to report changes to

F. Conclusion

As may be evident from the information described above, nonprofit organizations are subject to various tax, accounting, and financial reporting requirements. We suggest that you consult with an accountant knowledgeable about nonprofit corporations to help establish appropriate accounting and reporting procedures.

In addition, this memorandum outlines many of the legal requirements and challenges the Corporation will face in order to maintain its corporate and tax-exempt status. The information provided is summary in nature and designed to give those responsible for the management and operation of the Corporation a general idea of the issues that may arise, but it is not intended to substitute for on-going consultation with an attorney.

your organization's address, name, mission/specific purpose, scope of activities, and other significant changes to your bylaws on your annual federal and state information returns and to the Attorney General.